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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1955

No. 373

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER,

vs.

PHILIP J. LoBUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

PETITION FOR CERTIORARI FILED SEPTEMBER 2, 1955

CERTIORARI GRANTED NOVEMBER 14, 1955

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1955

No. 373

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

vs.

PHILIP J. LoBUE.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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1 In the Tax Court of the United States

DOCKET NO. 41595

PHILIP J. LOBUE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

APPEARANCES:

For Petitioner: Richard F. Barrett, Esq.
For Respondent: John E. Mahoney, Esq.

DOCKET ENTRIES

1952

June 4.—Petition received and filed. Taxpayer notified. Fee paid.

June 9.—Copy of petition served on General Counsel.

June 4.—Request for Circuit hearing in New York filed by taxpayer. 6/16/52—Granted.

July 28—Answer filed by General Counsel.

August 5—Copy of answer served on taxpayer, New York, N.Y.

1953

July 15—Hearing set October 5, 1953, New York, N. Y.

October 14.—Hearing had before Judge Rice on the merits; Stipulation of Facts and exhibits 1-A thru 13-M filed; Briefs due December 28, 1953; Replies due January 18, 1954.

November 2.—Transcript of Hearing 10/14/53 filed.

December 28.—Brief filed by taxpayer.

December 28.—Motion for extension to 1/18/54 to file brief filed by General Counsel. 12/30/53—Granted.

1954

January 14.—Brief filed by General Counsel.

January 15.—Copy of brief served on General Counsel.

February 4.—Motion for extension to February 26, 1954 to file reply brief filed by taxpayer. 2/5/54—Granted.

February 26.—Reply brief filed by taxpayer. 3/1/54—Copy served.

May 28.—Findings of Fact and Opinion filed, Judge Rice, Decision will be entered under Rule 50. 6/3/54—Copy served.

July 8.—Agreed Computation for entry of Decision filed by General Counsel.

July 9.—Decision entered. Judge Rice. Dec. 12.

1954

October 8.—Petition for Review by U.S. Court of Appeals for the Third Circuit, filed by General Counsel.

October 8.—Notice of filing petition for review sent to Richard F. Barrett, filed.

2 *1954*

October 19.—Proof of service of petition for review filed. (Richard F. Barrett)

November 10.—Motion for extension to January 6, 1955 for filing the record and docketing the appeal, filed by General Counsel.

November 12.—Order extending time to 1/6/55 for filing the record and docketing the appeal, entered.

December 22.—Certified copy of Order of Court of Appeals for the Third Circuit, extending time to February 21, 1955 for filing the record and docketing the appeal, filed.

3 The Tax Court of the United States

(File endorsement omitted)

(Title omitted)

PETITION—Filed June 4, 1952

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau Symbols BG-90D) dated March 12, 1952, and as a basis of his proceeding alleges as follows:

1. The petitioner is an individual with his residence at 106 Leonia Avenue, Leonia, New Jersey. The returns for the periods here involved were filed with the Collector for the Fifth District of New Jersey.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on March 12, 1952.

3. The taxes in controversy are income taxes for the calendar years 1946 and 1947 and in the amounts of $3,031.63 and $211.40, respectively.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

4 *Assignment of Error*

(1) The respondent has erred in his determination that the petitioner received taxable compensation for services in 1946 and 1947 by reason of his exercise of stock options previously granted to him by his employer, the Michigan Chemical Corporation.

(2) The respondent has further erred in his determination of the amount of such alleged compensation and in failing to determine that the exercise of said options occurred in the respective years 1945, 1946 and 1947.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

Statement of Facts

(1) The petitioner has at all times used the cash receipts and disbursements method of reporting income and filed his Federal income tax returns on a calendar year basis.

(2) The petitioner became an employee of the Michigan Chemical Corporation (hereinafter called the "Corporation") in September, 1941, and was employed by the Corporation as a sales manager commencing on said date and during the period January 1, 1944 through February, 1947.

(3) The Corporation was organized as a corporation on February 21, 1935 under the laws of Michigan for the purpose
5 of producing and selling chemical products and has conducted such a business at all times since.

(4) The Corporation in March, 1944 by duly taken corporate action established a stock option plan for the benefit of certain key employees.

(5) Under the terms of said plan, 10,000 shares of authorized and unissued common stock of the Corporation were allocated for sale to key employees, as determined by the Board of Directors, at a price of $5.00 per share during the period commencing March 21, 1944 and ending March 21, 1947.

(6) Under the terms of said plan, the stock could not be paid for or received by the employee prior to June 30, 1945, and participation in the plan and receipt of the stock by the employee was contingent upon his employment by the Corporation on June 30, 1945 and the sale of the stock being in accordance with State and Federal laws and regulations.

(7) Pursuant to said plan, the petitioner on January 18, 1945 was granted a non-assignable option to purchase 150 shares of stock in accordance with the terms of said plan.

(8) The petitioner on or about May 1 exercised said option, effective January 2, 1945, to purchase 150 shares of stock and delivered to the Corporation his promissory note payable to the Corporation in the amount of $750.00, dated January 2, 1945 and payable March 1, 1947.

6 (9) The Corporation in 1945 pursuant to said plan granted similar options to purchase varying amounts of stock to thirty-six other employees.

(10) Pursuant to said plan, the petitioner on January 2, 1946 was granted a non-assignable option to purchase an additional 150 shares of stock in accordance with said plan.

(11) The petitioner thereafter on January 3, 1946 exercised said option, effective January 2, 1946, to purchase said additional 150 shares of stock and delivered to the Corporation his promissory note payable to the Corporation in the amount of $750.00 dated January 2, 1946 and payable March 1, 1947.

(12) The Corporation in 1946 pursuant to said plan granted similar options to purchase varying amounts of stock to forty-seven other employees.

(13) The petitioner on May 23, 1946 paid the said notes dated January 2, 1945 and January 2, 1946 in full, and certificates for 300 shares were issued to him on May 30, 1946.

(14) Pursuant to said plan, the petitioner on January 2, 1947 was granted a non-assignable option to purchase an additional 40 shares of stock in accordance with said plan.

(15) The petitioner on February 23, 1947 exercised said option to purchase an additional 40 shares of stock, made payment therefor to the Corporation in the amount of $200.00 and certificates for said 40 shares were issued to him on March 2, 1947.

7 (16) The Corporation in 1947 pursuant to said plan granted similar options to purchase varying amounts of stock to seventy-five other employees.

(17) The petitioner was employed by the Corporation in each of the years 1945 to 1947, inclusive, at an annual rate of $6,600.00 and salary was paid to him at said rate in each of said years.

(18) The aforesaid options to purchase the Corporation's stock were not part of the petitioner's employment contract with the Corporation and his continued employment by the Corporation was not dependent upon his receipt of said options.

(19) The receipt, retention or exercise by the petitioner of said options was not contingent upon or related to his continued employment with the Corporation beyond June 30, 1945.

(20) The said options were not intended by the Corporation or the petitioner to constitute additional compensation but were granted to permit the petitioner to acquire a proprietary interest in the Corporation and to provide him with the interest in the successful operation of the Corporation deriving from an ownership interest.

(21) The fair market value of the common stock of the Corporation at the date of its adoption of the stock option
8 plan in March, 1944 was not in excess of $5.00 per share.

(22) The fair market value of said stock at the dates of the exercise of the said options by the petitioner in 1945, 1946 and 1947 were respectively $5.00, $10.00 and $10.00 per share.

(23) The fair market values of said stock on June 30, 1945 and May 23, 1946 were respectively $7.50 and $15.00 per share.

(24) The fair market value of said stock on the date of the issuance to the petitioner of certificates for 300 shares in 1946 was $10.00 per share, and on the date of the issuance to the petitioner of certificates for 40 shares in 1947 was $10.00 per share.

(25) The fair market value of said stock in the period January 1, 1945 to February 23, 1947 was at no time in excess of $15.00 per share.

WHEREFORE, the petitioner prays that this Court may hear the proceeding and may adjudge:

I. That the exercise of the three several stock options by the petitioner did not result in compensation to the petitioner and that no income taxable to the petitioner arose therefrom in the years 1946 and 1947.

9 II. In the alternative, that the three several stock options were exercised on January 2, 1945, January 3, 1946 and February 23, 1947, respectively, and that the compensation taxable to the petitioner as the result of such exercise is in the amounts of $750.00 for the year 1946 and $200.00 for the year 1947.

III. That the petitioner is entitled to such other and further relief as the Court shall determine.

RICHARD F. BARRETT,
30 Federal Street,
Boston, Massachusetts,
Counsel for Petitioner.

10 *Duly sworn to by Philip J. LoBue. Jurat omitted in printing.*

11 EXHIBIT "A" TO PETITION

U. S. Treasury Department
Office of Internal Revenue Agent in Charge
1006 Broad Street
Newark 2, New Jersey

Internal Revenue Service
90D

March 12, 1952

Mr. Philip J. LoBue,
106 Leonia Avenue,
Leonia, New Jersey,

Dear Mr. LoBue:

You are advised that the determination of your income tax liability for the taxable year(s) ended December 31, 1946 and

December 31, 1947 discloses a deficiency of $3,088.63 and $464.11, respectively, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia, in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to this office for the attention of BG-90D. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earlier.

Very truly yours,

JOHN B. DUNLAP,
Commissioner,
By (S.) R. O. THORNTON,
Internal Revenue Agent in Charge.

Enclosures:

Statement,
Form 1276,
Agreement Form.

12 STATEMENT

Philip J. LoBue
106 Leonia Avenue
Leonia, New Jersey

Tax liability for the Taxable Years ended December 31, 1946 and December 31, 1947.

Income Tax

Year	Deficiency
1946	$3,088.63
1947	464.11
	$3,552.74

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated May 16, 1949; to your protest dated October 11, 1949 and to the statements made at the conferences held on October 10, 1950, March 6, 1951 and June 5, 1951.

Taxable Year Ended December 31, 1946
Adjustments to Net Income

Net income as disclosed by return		$ 9,236.40
Unallowable deductions and additional income:		
(a) Compensation	$8,100.00	
(b) Business income	200.00	8,300.00
Corrected net income		$17,536.40

Explanation of Adjustments

(a) It has been determined that you obtained compensation, unreported, in the amount of $8,100.00, from the exercise of an option granted by Michigan Chemical Corporation.

(b) It has been further determined that your net profit from business is $4,002.06 instead of $3,802.06, as reported by you.

13 Philip J. LoBue

Taxable Year Ended December 31, 1946

Computation of Income Tax

1. Net Income	$17,536.40	
2. Less: Surtax and normal tax exemption	2,000.00	
3. Balance subject to tax	$15,536.40	
4. Tentative combined normal tax and surtax		$ 4,982.11
5. Less: 5% of item 4		249.11
6. Income tax liability		$ 4,733.00
7. Income tax liability disclosed by return		1,644.37
8. Deficiency of income tax		$ 3,088.63

Taxable Year Ended December 31, 1947

Adjustments to Net Income

Net income as disclosed by return		$12,762.61
Unallowable deductions and additional income:		
(a) Compensation	$580.00	
(b) Salary—Mathematical error	50.00	
(c) Business income	650.09	1,280.00
Corrected net income		$14,042.61

Explanation of Adjustments

(a) It has been determined that you obtained compensation, unreported, in the amount of $580.00, from the exercise of an option granted by Michigan Chemical Corporation.

(b) It has been further determined that you omitted $50.00 salary from Michigan Chemical Corporation as the result of a mathematical error.

(c) It has been further determined that your net profit from business is $14,018.53 instead of $13,368.53, as reported by you.

14 Philip J. LoBue

Taxable Year Ended December 31, 1947

Computation of Income Tax

1. Net income	$14,042.61	
2. Less: Surtax and normal tax exemption	2,000.00	
3. Balance subject to tax	$12,042.61	
4. Tentative combined normal tax and surtax		$3,418.32
5. Less: 5% of item 4		170.92
6. Income tax liability		$3,247.40
7. Income tax liability disclosed by return		2,783.29
8. Deficiency of income tax		$ 464.11

15 Return receipt requested.

Registered 369961, from James J. Sullivan, 230 Park Avenue, New York 17, N. Y.

To Tax Court of the United States, Office of the Clerk, Internal Revenue Building, Washington, D. C.

16 [File endorsement omitted]

The Tax Court of the United States

[Title omitted]

REQUEST FOR DESIGNATION OF PLACE OF HEARING—Filed June 4, 1952

Now comes the petitioner, by his attorney, Richard F. Barrett, and in accordance with Rule 26 of the Court's Rules of Practice,

REQUESTS that the Court designate that the hearing in the above-entitled proceeding be held at New York, New York, in order to afford thereby the petitioner the opportunity to prepare and present

said proceeding for trial with a minimum of inconvenience and expense.

RICHARD F. BARRETT,
30 Federal Street,
Boston, Massachusetts,
Counsel for Petitioner.

17 [File endorsement omitted]

The Tax Court of the United States

[Title omitted]

ANSWER—Filed July 28, 1952

Now comes the Commissioner of Internal Revenue by his attorney, Charles W. Davis, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition in the above-entitled proceeding admits and denies as follows:

1. Admits the allegations of paragraph 1 of the petition.

2. Admits the allegations of paragraph 2 of the petition.

3. Admits that the taxes in controversy are income taxes for the taxable years 1946 and 1947. Denies the remaining allegations of paragraph 3 of the petition.

4. (1) and (2) Denies the allegations of paragraphs 4 (1) and (2) of the petition.

5. (1) Admits that the petitioner filed his income tax return on a calendar year basis. Denies the remaining allegations of paragraph 5 (1) of the petition.

(2) to (12) Denies the allegation of paragraphs 5 (2) to (12) inclusive, of the petition.

18 (13) Admits that in the taxable year 1946, the petitioner paid for, and there was issued to him certificates for 300 shares of Michigan Chemical Corporation. Denies the remaining allegations of paragraph 5 (13) of the petition.

(14) Denies the allegations of paragraph 5(14) of the petition.

(15) Admits that in the taxable year 1947, the petitioner exercised an option to purchase an additional 40 shares of stock of the Michigan Chemical Corporation, made payment therefor to said Corporation in the amount of $200.00 and certificates for said 40 shares were issued to him. Denies the remaining allegations of paragraph 5(15) of the petition.

(16) to (25) Denies the allegations of paragraphs 5 (16) to (25), inclusive, of the petition.

6. Denies generally each and every allegation of the petition not hereinabove specifically admitted, qualified, or denied.

WHEREFORE, it is prayed that the relief sought in the petition be denied.

CHARLES W. DAVIS, JR.,
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:

HARTFORD ALLEN,
District Counsel,
JOHN E. MAHONEY,
Attorney,
Bureau of Internal Revenue.

19 The Tax Court of the United States

[Title omitted]

SERVICE OF ANSWER AND NOTICE OF HEARING (omitted in Printing)

20 [File endorsement omitted]

The Tax Court of the United States

[Title omitted]

(File endorsement omitted.)

NOTICE OF SETTING OF PROCEEDING FOR HEARING—CIRCUIT CALENDAR —July 15, 1953

TAKE NOTICE that a Division of The Tax Court of the United States will sit in 5050 Grand Central Terminal Bldg., 70 East 45th St. beginning October 5, 1953, New York, N. Y.

Hearings will be held in all proceedings shown on the attached list. The list will be called promptly at 10:00 a.m., as indicated, and you will be expected to answer the call at that time and be prepared for trial when reached. No continuance will be granted except for extraordinary cause. Failure to appear will be taken for cause for dismissal in accordance with the Rules of Practice, and you are in all other respects expected to be familiar with such rules.

Respectfully,

Clerk.

To: Richard F. Barrett, Esq.
30 Federal St.
Boston, Mass.

mal

21 The Tax Court of the United States

MINUTES OF PROCEEDINGS.

Date, October 14, 1953. Place, Newark New York. Docket No. 41595. Proceeding, Philip J. LoBue. Assigned to Judge Rice, Division No. 12.

Counsel:

For Petitioner, Richard F. Barrett, Esq., 30 Federal Street, Boston, Mass.
For Respondent, John E. Mahoney, Esq.,
Stenographic Reporter, M. Moore.
Hearings: 12:00, 12:40.
Sub Transcript Ordered Yes.
On the merits: Yes.
Filed at hearing: Stip of facts and exhibits 1A thru 13M.
Petitioner's brief: Dec. 28, 1953.
Respondent's brief: Dec. 28, 1953.
Witnesses for Petitioner: T. C. Davis.
Reply: Jan. 18, 1954, Jan. 18, 1954.

EXHIBITS

Petitioner's Stip of facts and Exhibits.
Number and describe: 1A thru 13M.
14—Copy annual report 1944.
15—Copy annual report 1945.
16—Copy annual report 1947.
17—Copy annual report 1947.
Respondent's letter and describe, N-1946 return, O-1947 return.

(Signed) CORRIDON L. JONES,
Deputy Clerk.

22 (File endorsement omitted)

The Tax Court of the United States

(Title omitted)

STIPULATION

It is hereby stipulated that for the purposes of this proceeding the following statements shall be accepted as facts without prejudice to the right of either party to introduce other and further evidence not inconsistent therewith:

1. The petitioner is an individual with his residence at 106 Leonia Avenue, Leonia, New Jersey.

2. The petitioner filed his Federal income tax returns for his taxable years 1946 and 1947 with the Collector for the Fifth District of New Jersey and filed said returns on a cash receipts
23 and disbursements and calendar year basis.

3. The petitioner entered the employ of the Michigan Corporation (hereinafter called the "Corporation") in September, 1941 and was employed by the Corporation as manager of the New York Sales Division from said date until February 28, 1947, upon which latter date his employment with the Corporation terminated.

4. The Corporation was organized as a corporation under the laws of Michigan on February 21, 1935 for the purpose of producing and selling chemical products and has conducted such a business at all times since.

5. The petitioner was employed by the Corporation and there was no written contract covering the terms and conditions of his employment. Salary paid to the petitioner by the Corporation during the years 1944, 1945, 1946 and 1947 to February 28, 1947 was respectively as to each of said years $500.00, $500.00, $550.00 and $550.00 per month.

6. On March 21, 1944 at an annual meeting of stockholders of the Corporation, a resolution, a copy of which is annexed hereto as Exhibit 1-A and made a part hereof, was adopted setting
24 aside 10,000 shares of the Corporation's stock for sale to key employees of the Corporation. On the same date, the Board of Directors of the Corporation adopted a resolution, a copy of which is annexed hereto as Exhibit 2-B and made a part hereof, to effectuate a sale of said stock to the Corporation's key employees.

7. The aforesaid resolutions (Exhibits 1-A and 2-B) and letters written to the petitioner dated June 29, 1944, January 18, 1945, January 1, 1946 and January 2, 1947 by Colonel T. C. Davis, Executive Vice President of the Corporation in the years 1944 through 1946 and President of the Corporation in the year 1947, copies of which are annexed hereto as Exhibits 3-C, 4-D, 5-E and 6-F and made a part hereof, set forth the terms of the said sale of stock to key employees.

8. During the years 1944 through 1947, the Corporation had a single class of stock authorized and outstanding, consisting of common stock of a par value of $1.00 per share, and constituting the stock offered to the key employees under said plan.

9. Under date of June 15, 1945, the sale of the said stock of the Corporation was authorized by the Michigan Corporation
25 and Securities Commission of the State of Michigan and an order entered by said Commission, a copy of which is annexed hereto as Exhibit 7-G and made a part hereof. Said order expired on December 15, 1945 but was extended to December 15,

1946 and June 15, 1947 by further orders of said Commission dated December 4, 1945 and December 10, 1946 respectively, copies of which are annexed hereto as Exhibits 8-H and 9-I, and made a part hereof.

10. The petitioner in 1944 by letter from Colonel T. C. Davis, Executive Vice President of the Corporation, (Exhibit 3-C) was notified of the tentative assignment to him of stock under said plan. On January 18, 1945, the petitioner pursuant to said plan was granted the right to purchase 150 shares of stock in accordance with the terms of said plan by letter to him from Colonel T. C. Davis, Executive Vice President of the Corporation, dated January 18, 1945 (Exhibit 4-D).

11. The petitioner on or about May 1, 1945, delivered to the Corporation for said 150 shares his promissory note payable to the Corporation in the amount of $750.00, dated January 2, 1945 and payable March 1, 1947, a copy of which is annexed hereto as Exhibit 10-J and made a part hereof.

12. The Corporation in 1945 pursuant to said plan granted similar rights on the same terms and conditions to 36 other
26 key employees to purchase stock in varying amounts totaling 3,825 shares.

13. On January 1, 1946, the petitioner pursuant to said plan was granted the right to purchase an additional 150 shares of said stock in accordance with the terms of said plan by letter to him from Colonel T. C. Davis, Executive Vice President of the Corporation, dated January 1, 1946 (Exhibit 5-E).

14. The petitioner thereafter on January 3, 1946 delivered to the Corporation for said 150 shares his promissory note payable to the Corporation in the amount of $750.00, dated January 2, 1946 and payable March 1, 1947, a copy of which is annexed hereto as Exhibit 11-K and made a part hereof.

15. The Corporation in 1946 pursuant to said plan granted similar rights on the same terms and conditions to 47 other employees to purchase varying amounts of said stock totaling 3,950 shares.

16. On January 2, 1947, the petitioner pursuant to said plan was granted the right to purchase an additional 40 shares of said stock in accordance with the terms of said plan by letter to him from Colonel T. C. Davis, Executive Vice President of the Corporation, dated January 2, 1947 (Exhibit 6-F).

27 17. The Corporation in 1947 pursuant to said plan granted similar rights on the same terms and conditions to 75 other employees to purchase varying amounts of said stock totaling 2,475 shares.

18. The petitioner on February 3, 1947, purchased 40 shares of said stock pursuant to the said right granted to him on January 2, 1947 and made payment therefor to the Corporation in the

amount of $200.00. Certificates for said 40 shares were issued to him on February 4, 1947.

19. The petitioner on May 24, 1946 paid the said notes dated January 2, 1945 (Exhibit 10-J) and January 2, 1946 (Exhibit 11-K) given by him to the Corporation as aforesaid in connection with the aforesaid rights for 300 shares of said stock granted to him on January 18, 1945, and January 1, 1946, by delivery to the Corporation of his check payable to its order in the amount of $1,500.00. Certificates for 300 shares of said stock were thereafter issued to him on May 25, 1946.

20. No deduction was taken by the Corporation on its income tax return for the year ended December 31, 1945 with respect to stock allocated to employees under said plan and the Corporation made no application for nor did it receive approval from the Salary Stabilization Unit for the granting to its key employees of said rights to purchase stock.

28 21. For its taxable years ended December 31, 1946 and December 31, 1947, the Corporation deducted on its income tax returns amounts described as the excess of market value at exercise date over option price of 3,900 shares of said stock sold to employees during 1946 and 5,665 shares of said stock sold to employees during 1947, in the respective amounts of $81,372.50 and $81,798.25, which deductions were not recorded on its books.

22. The general nature and extent of the petitioner's employment and duties with and for the Corporation remained the same during the years 1944 through 1947.

23. On or about February 15, 1947, entries were made by the Corporation in its books crediting to capital surplus and debiting to profit and loss as of December 31, 1946, the sum of $31,600.00 with the explanation "Excess of estimated Fair Value at allotment date of the option price ($5 per share) of 3,950 shares of common stock as to which rights to purchase were allotted to employees during the year". On or about February 15, 1948, entries were made by the Corporation on its books crediting to capital surplus and debiting to profit and loss, as of December 31, 1947, the sum of $34,650.00 in respect of 2,475 shares with a similar explanation of the entry.

24. Copies of Employee's Copy furnished to the petitioner
29 of Withholding Statements, Form W-2, filed by the Corporation with the Internal Revenue Service of the U. S. Treasury Department for the years 1946 and 1947 are annexed hereto as Exhibits 12-L and 13-M and made a part hereof.

25. The Annual Report of the Corporation to its stockholders for the year 1944, dated February 28, 1945, stated as follows:

> "Stockholders at the annual meeting held on March 21, 1944 approved the proposed action of the Board of Directors to set

aside 15,000 of the authorized but unissued common stock of the corporation for sale to such key employees as determined by the Board of Directors and, as from time to time determined by said Board, during the next three years at $5.00 per share, being the approximate market value of said stock at that time. I am pleased to advise you that pursuant to action of stockholders, above referred to, and subject to requirements fixed by the Board, 8,825 shares of the unissued stock of the corporation have been allotted to 38 key employees for purchase at $5.00 per share. This leaves a balance of 6,175 shares of stock to be allotted as an incentive to key employees during the next two years."

26. The Annual Report of the Corporation to its stockholders for the year 1945, dated February 21, 1946, stated as follows:

"All of the 4,039 shares under option at $15 per share were purchased, as well as 5,400 shares under option to employees at $5 per share and 4,369 shares under the provisions of the outstanding warrants. These transactions caused an increase in the outstanding common shares of 13,808 during the year for which the company received $109,430. There were 3,950 options allocated to 49 key employees for 1945, leaving 2,475 of the 10,000 shares authorized by stockholders for sale to employees on or before March 21, 1947. The allocation of these options to employees as an incentive also assures their participation in the growth of the Corporation."

27. The Annual Report of the Corporation to its stockholders for the year 1946, dated March 6, 1947, stated as follows:

"Before the close of 1946 the remaining 4,381 warrants were exercised. Also options representing 3,900 shares were exercised by employees and the remaining 2,475 shares were allocated to key employees, being the last of the 10,000 shares authorized by stockholders on March 21, 1944 to be sold to employees at $5 per share as part of a program to increase their proprietary interest in the progress of the Company."

28. The Annual Report of the Corporation to its stockholders for the year 1947 stated as follows:

"Common stock now outstanding amounts to 297,077 shares and this figure also reflects the completion of options to employees to purchase 2,475 shares of common stock. There are no further options outstanding."

29. The fair market value of said stock throughout the following months was as follows:

March, 1944	$ 4.50
January, 1945	8.69
May, 1945	13.25
June, 1945	14.38
31 January, 1946	19.25
April, 1946	25.25
May, 1946	30.50
February, 1947	19.50

RICHARD F. BARRETT,
Counsel for Petitioner.
KENNETH W. GEMMILL,
Acting Chief Counsel,
Internal Revenue Service.

32 EXHIBIT 1-A TO STIPULATION

MICHIGAN CHEMICAL CORPORATION
St. Louis, Michigan

MINUTES OF ANNUAL MEETING OF STOCKHOLDERS OF MICHIGAN CHEMICAL CORPORATION ON MARCH 21, 1944

"RESOLVED, That the proposed action of the Board of Directors to set aside 10,000 shares of the authorized but unissued common stock of the Corporation for sale to such key employees as determined by the Board of Directors, and as from time to time determined by said Board, during the next three years, at $5.00 per share, being the approximate market value of said stock at the present time, be and the same hereby is approved."

33 EXHIBIT 2-B TO STIPULATION

MICHIGAN CHEMICAL CORPORATION
St. Louis, Michigan

MINUTES OF DIRECTORS MEETING OF MICHIGAN CHEMICAL CORPORATION ON MARCH 21, 1944

"WHEREAS, the shareholders of Michigan Chemical at their Annual Meeting held on March 21, 1944 recommended and approved the action to set aside certain shares of the common stock of the Corporation for sale to Officers and key employees.

NOW, THEREFORE, BE IT RESOLVED, That the action to set aside 10,000 shares of the authorized but unissued common stock of the

Corporation for sale to such key employees as determined by the Board of Directors, and as from time to determined by said Board, during the next three years, at $5.00 per share, being the approximate market value of said stock at the present time, be and the same hereby is approved."

34 EXHIBIT 3-C OF STIPULATION

June 29, 1944.

Mr. Philip J. LoBue
Palisades Park, N. J.

Dear Phil:

As you know, the stockholders of your company at their meeting in March, 1944, set aside ten thousand shares of the common stock of Michigan Chemical Corporation for allotment to key employees, under a purchase plan at the price of $5.00 per share. The purpose of this is to provide an incentive to key employees and especially to permit such men to participate in the success of the Company. This is a method or plan which has been followed by many of the leading American corporations.

The stock has been set up in the form of options running for a maximum of three years, or such lesser period of time as the Committee may determine. Allotment of the stock will be made by the Committee to the key men of the Company on results accomplished. In other words, you will stand on your own record and participate in the stock purchase plan to the extent of your efforts, cooperation and results.

In order that our plan can begin to function, it has been decided now to tentatively allot ten shares of stock to each one of a selected list of key employees, subject to the following conditions:

1. This tentative allotment will only become definite on January 1st, 1945, and only provided the Company's operations for the year 1944 have been profitable.

2. The stock will be issued by the Company direct to the employee upon payment therefor at the rate of $5.00 per share and as directed by the Committee.

3. The stock cannot be paid for nor received by the employee before June 30th, 1945. Participation in the plan or receipt of stock is entirely contingent upon his being employed by Michigan Chemical at that time and that such sales of stock are made in accordance with governmental laws or regulations.

4. Should employment with Michigan Chemical Corporation cease before June 30th, 1945, any allotments of stock which

may be made to you on January 1st, 1945 will become null and void.

35 5. Should the employee on June 30th, 1945 so desire, arrangements will be made to extend the time for purchase of the stock to some future date to be determined by the Committee.

I am pleased to advise you that your name has been included in the names of key men to receive a tentative assignment of ten shares of Michigan Chemical stock, subject to the above conditions. The monthly figures during the year will show the results of your effort, both in your own department and in the plant as a whole. On or about January 1, 1945, a much larger portion of stock will be made available to the Committee for assignment to key employees on the basis of results accomplished. You may be assigned a greater or less amount of stock based entirely upon your individual results and that of the entire organization. Basic factors which should directly affect your accomplishments in departments will be labor costs both productive and non-productive, general expense items, maintenance of equipment, improvement in the efficiency of operations, increase in production, improvements in quality, simplified methods, new products, general operations in your department and cooperation with other direct and indirect departments.

May I suggest that you select those things wherein you can make the greatest contribution and strive to make the kind of record of which you and I may be proud.

May I also take this opportunity to congratulate you on being included in the initial list of those who have been selected as competent to perform outstanding service and thereby participate in the future of the Michigan Chemical Corporation.

Very truly yours,

(S.) T. C. DAVIS,
Executive Vice President.

T. C. Davis:ag

36 EXHIBIT 4-D TO STIPULATION

January 18, 1945

Mr. Philip J. LoBue
126 Leonia
Leonia, New Jersey

Dear Phil:

You will recall that I wrote you under date of June 29, 1944, advising that your name had been included in a selected list of key employees to participate in a stock purchase plan provided by

the stockholders at their meeting in March, 1944. In that letter, you were advised that you had tentatively been allotted ten shares of stock, which could be purchased by you at $5.00 per share, subject to the following conditions:

1. This tentative allotment will only become definite on January 1st, 1945, and only provided the Company's operations for the year have been profitable.

2. The stock will be issued by the Company direct to the employee upon payment therefor at the rate of $5.00 per share and as directed by the Committee.

3. The stock cannot be paid for nor received by the employee before June 30th, 1945. Participation in the plan or receipt of stock is entirely contingent upon his being employed by Michigan Chemical at that time and that such sales of stock are made in accordance with governmental laws or regulations.

4. Should employment with Michigan Chemical Corporation cease before June 30th, 1945, any allotment of stock which may be made to you on January 1st, 1945, will become null and void.

5. Should the employee on June 30th, 1945, so desire, arrangements will be made to extend the time for purchase of the stock to some future date to be determined by the Committee.

37 I am pleased to advise you that the operations of the Company, though leaving much to be desired, were moderately profitable for the year 1944. The tentative allotment of stock made to you last June has now been changed and subject to the above conditions, you are definitely allotted 150 shares of the unissued common stock of the Michigan Chemical Corporation. This allotment of stock was made by the Committee and is in recognition of your contribution and efforts in making the operation of the Company successful.

The rights to subscribe to this stock are not transferable and will accrue to you directly providing all the conditions enumerated above are fully complied with.

As you know, we must continue to contribute our every effort toward the success of Michigan Chemical Corporation. There is much yet to be done to bring the Company along towards the attainment of our goal. This will require the most intensive work on the part of all of us during the current year. That we have a great opportunity is, I am sure, well known to you.

May I again congratulate you and suggest that you, as a stockholder, should be interested in seeing that the operations of the Company are as efficient as possible.

You will, of course, understand that further allotments of stock under our plan will be recommended by the Committee during 1945 and 1946 providing the conditions and requirements are met. It is up to you to justify your participation in the plan during the next two years.

Very truly yours,

T. C. DAVIS,
Executive Vice-President.

T. C. Davis:ag.

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38 EXHIBIT 5-E TO STIPULATION

New York, N. Y.,
January 1, 1946.

Mr. Philip J. LoBue
Leonia, New Jersey

Dear Phil:

It is with the greatest pleasure that I am writing to inform you that the Board of Directors of Michigan Chemical Corporation have approved the Committee's recommendation for the allotment of common stock of the Corporation to certain employees, for purchase at the price of $5.00 per share.

As you know, the stockholders at their meeting held in March, 1944, generously set aside 10,000 shares of the Corporation's common stock for purchase, over a period of three years, by selected employees at the price of $5.00 per share, which was the then approximate market price. You have from time to time been advised of the requirements incident to your participation in this purchase plan.

For the year 1945 the Committee has allotted you 150 shares of the common stock of Michigan Chemical Corporation, subject to your acquisition of these shares from the company at the rate of $5.00 per share on or before March 21, 1947. I am sure that you appreciate that generally, the value of common stock equities is closely tied to the success or failure of the corporation issuing such stock.

The Committee's selection of the names of employees to receive the right to purchase this stock and the number of shares assigned to each selectee is determined by the Committee after a careful appraisal of the individual's contribution to the company in the way of job performance during the past year. In other words, the extent of your participation in the plan is based on how well you handled your job during the year. Outstanding service to the com-

pany is given added recognition in determining the number of shares assigned. In this connection, I would like to point out to you that it is but natural to expect a more rigid comparative appraisal of your efforts in the future.

39 It is important we keep in mind that this plan permits you to participate in the future of your company on what now appears to be a very attractive basis. Any company is dependent upon its management and personnel for such success as may accrue to it. You are expected to contribute your share to our success. As a potential stockholder, you personally have a very definite reason to strive for the successful operation of your company beyond the mere holding of a job.

I am sure you recognize that there is much waste in most of our operations. Waste of materials, steam, water and of still greater importance the waste of time and labor. You should make every effort to correct these faults and where you know them to exist in parts of the plant beyond your control, you should not hesitate to point them out to those responsible.

The Michigan Chemical Corporation is your company.

You should feel in it the pride of ownership.

I congratulate you.

Yours very truly,

T. C. DAVIS,
Executive Vice-President.

T. C. Davis:ag.

40 EXHIBIT 6-F TO STIPULATION

January 2, 1947

Mr. Philip J. Lobue
Palisades Park, New Jersey

Dear Phil:

It is with the greatest of pleasure that I am writing to inform you that the Board of Directors of Michigan Chemical Corporation has approved the Committee's recommendation for the allotment of the available common stock of the corporation at the price of $5 per share.

This allocation represents the balance of the 10,000 shares of the corporation's common stock which was made available by the Stockholders at their meeting held in March, 1944, for allocation to and purchase by selected employees over a three year period at a price of $5 per share, which was the approximate market value at that time. This letter will supplement the information furnished

you from time to time pertaining to your participation in this plan.

For the year 1946, the Committee has allocated you 40 shares of the available common stock of the Michigan Chemical Corporation, subject to your acquisition of these shares from the Corporation at a price of $5 per share on or before March 21, 1947. It is urged that all stock be purchased prior to March 10, 1947, to allow sufficient time for stock certificates to be issued by the stock transfer agents prior to the above mentioned expiration date.

It is anticipated that some of the employees to whom stock allotments have been made will have questions regarding the procedure for purchasing the stock or that possibly they will not have available all the cash necessary to enable them to purchase the stock prior to the expiration date. The foregoing or any other matters pertaining to the stock allotments can be discussed with Mr. C. G. Woods.

The allocations for 1946, as in past years, have been determined by the Committee after a careful appraisal of the
41 employee's contribution to the corporation's progress during the past year. The allocations are not as large as in past years. This is due to the fact that the number of shares available was less than in prior years and the number of employees to whom allocations were made was greater than previously. However, the value per share allocated is considerably greater this year than in previous years.

Again I wish to call your attention to the fact that these allocations afford you an opportunity to become a stockholder and thus participate in the future earnings of the corporation. The future progress and earnings of the corporation are largely dependent upon the loyal cooperation and efforts of each of its employees. The corporation's plans for 1947 include further expansion which should bring to you greater opportunities for participation in the future of your company both as an employee and stockholder. Incidentally, an employee should feel a certain amount of pride in also being a stockholder.

I congratulate you on having earned this recognition given to you by the Committee and trust that your future services, suggestions and interest in the corporation's welfare will warrant even greater recognition.

Very truly yours,

T. C. DAVIS,
President.

T. C. Davis: ag

42 EXHIBIT 7-G TO STIPULATION

State of Michigan
(State Seal)

Secretary: Ruth Ruen.
Harry F. Kelly, Governor.
Howard M. Warner, Commissioner.
John F. Hueni, Deputy Commissioner.
Roy F. Delaney, Chief Securities Examiner.

Order Entered by
Michigan Corporation and Securities Commission
Detroit

June 15, 1945.

Application of MICHIGAN CHEMICAL CORPORATION, St. Louis, Michigan, covered by File No. C-14462, was considered, and 15,000 shares of unissued Common Stock, par value $1.00 a share, are hereby accepted for filing for sale at $5.00 a share as follows: (1) 5,000 shares to T. C. Davis, and (2) 10,000 shares to key employees of the company as designated by the Board of Directors, subject to the following conditions:

1. That the right to sell the 15,000 shares of unissued Common Stock, par value $1.00 a share, under this order shall expire on the 15th day of December, 1945, and this order shall be deemed to have automatically expired on said date as to all of said securities not sold prior to said date, unless otherwise provided by further order of the Commission.

2. That none of the securities accepted for filing under this order shall be issued or sold except for a money consideration and at the price hereinabove specified, without first securing the written permission of the Commission.

3. That no commission shall be allowed on the sale of said securities.

4. The Commission reserves the right to amend, alter, or revoke this order or any portion thereof at its discretion, subject to the provisions of Act 220, Public Acts of 1923, as amended, and regulations promulgated thereunder.

5. That the provisions of Act 220, Publics Acts of 1923, as amended, and the regulations promulgated thereunder, shall be observed in all respect in or in connection with the sale or offer of said securities.

6. In accepting this security for filing neither the State of Michigan nor the Michigan Corporation and Securities Commission has undertaken to pass upon the worth or value of the security mentioned or to recommend its purchase, nor shall the name "Michigan

Corporation and Securities Commission" be used in the advertising or offer of this security.

43 EXHIBIT 8-H TO STIPULATION

State of Michigan
(State Seal)

Ruth Ruen, Secretary.
Harry F. Kelly, Governor.
Howard M. Warner, Commissioner.
John F. Hueni, Deputy Commissioner.
Roy F. Delaney, Chief Securities Examiner.

Order Entered by
Michigan Corporation and Securities Commission
Detroit

December 4, 1945.

In accordance with Petition dated November 30, 1945, received and considered by this Commission,

IT IS ORDERED, That the Order dated June 15, 1945, of MICHIGAN CHEMICAL CORPORATION, St. Louis, Michigan, File No. C-14462, be hereby extended in full force and effect for a period of one year from December 15, 1945, and in pursuance thereof Condition 1 of said Order of June 15, 1945, is hereby amended to read as follows:

"That the right to sell securities under this order shall expire on the 15th day of December, 1946, and this order shall be deemed to have automatically expired on said date as to all of said securities not sold prior to said date, unless otherwise provided by further order of the Commission."

44 EXHIBIT 9-I TO STIPULATION

STATE OF MICHIGAN
(State Seal)

Harry F. Kelly, Governor,
Howard M. Warner, Commissioner,
John F. Hueni, Deputy Commissioner,
Edward J. Starkey, Chief Securities Examiner,
Secretary, Ruth Ruen.

Order Entered by
Michigan Corporation and Securities Commission
Detroit

December 10, 1946

In accordance with petition dated November 26, 1946, received and considered by this Commission,

IT IS HEREBY ORDERED, That the Order dated June 15, 1945, as amended, of MICHIGAN CHEMICAL CORPORATION, Saint Louis, Mich-

igan, covered by File No. C-14462, be and is hereby extended in full force and effect for a period of six months from December 15, 1946, and in pursuance thereof Condition 1 of said Order is amended to read as follows:

> "That the right to sell securities under this order shall expire on the 15th day of June, 1947, and this order shall be deemed to have automatically expired on said date as to all of said securities not sold prior to said date, unless otherwise provided by further order of the Commission."

Exhibit 10-J

$ 750.00 New York, New York January 2, 1945 1945

On March 1st, 1947 after date I promise to pay

to the order of Michigan Chemical Corporation

Seven Hundred Fifty and 00/100 Dollars

Payable at

Value received

No Due

Philip J. Lobue

Gilbert & Sons

MAY 23 1945 MICHIGAN

45

27

Exhibit 11-K

Exhibit 11-K

$ 750.00 New York, New York January 2nd, 1946

On March 1st, 1947 after date I promise to pay

to the order of -Michigan Chemical Corporation

-----Seven Hundred Fifty and 00/100---------- Dollars

PAID MAY 23 1946 MICHIGAN CHEMICAL CORPORATION

Payable at

Value received

No Due

Philip J. Lobbes

Gibbons SNP

Exhibit 12-L

Exhibit 12-L

Form W-2
U. S. Treasury Department
Internal Revenue Service

WITHHOLDING STATEMENT — 1946

Wages Paid and Income Tax Withheld

EMPLOYEE'S COPY

(DUPLICATE)

EMPLOYEE TO WHOM PAID (Print name, address, and Social Security No.)

Philip J. Lo Bue 063 01 5227
136 Leonia Avenue
Leonia, New Jersey

(To EMPLOYEE: Change name and address if not correctly shown)

Total wages (before payroll deductions) paid in 1946	Federal income tax withheld, if any	
$ 6,600.00	$ 784.80	

EMPLOYER BY WHOM PAID (Name, address, and S. S. identification No.)

MICHIGAN CHEMICAL CORPORATION
500 NORTH BANKSON
SAINT LOUIS, MICHIGAN 38-0826170

APP. B.I.R. 12-12-46

To EMPLOYEE:

This is your copy. Do not file with Collector.

If you use Employee's Optional Income Tax Return on back of the original Form W-2 as your return, you should make a record of your return below:

1. Write total of wages shown on this and all your other 1946 Withholding Statements $_____

2. Write total of all other wages, dividends, and interest $_____

3. Add lines 1 and 2. Write total here $_____

4c. If line 3 includes income of both husband and wife, show husband's income $_____; wife's income $_____

List of dependents claimed:

(Name) (Relationship)

(Name) (Relationship)

(Name) (Relationship)

(Name) (Relationship)

Exhibit 13-M

Exhibit 13-M

Form W-2
U. S. Treasury Department
Internal Revenue Service

WITHHOLDING STATEMENT — [illegible] 1947

Wages Paid and Income Tax Withheld

EMPLOYEE'S COPY

(DUPLICATE)

EMPLOYEE TO WHOM PAID (Print name, address, and Social Security No.)

Philip J. Lo Bue 063 01 52 7
106 Leonia Avenue
Leonia, New Jersey

(To EMPLOYEE: Change name and address if not correctly shown)

Total wages (before payroll deductions) paid in 1947	Federal income tax withheld, if any	
$550.00	$ 65.40	

EMPLOYER BY WHOM PAID (Name, address, and S. S. identification No.)

MICHIGAN CHEMICAL CORPORATION
500 NORTH BANKSON
SAINT LOUIS, MICHIGAN 38-0826470

APP. B.I.R. 12-12-46

To EMPLOYEE:

This is your copy. Do not file with Collector.

If you use Employee's Optional Income Tax Return on back of the original Form W-2 as your return, you should make a record of your return below:

1. Write total of wages shown on this and all your other 1946 Withholding Statements .. $_____
2. Write total of all other wages, dividends, and interest _____ $_____
3. Add lines 1 and 2. Write total here $_____
4c. If line 3 includes income of both husband and wife, show husband's income $_____; wife's income $_____

List of dependents claimed:

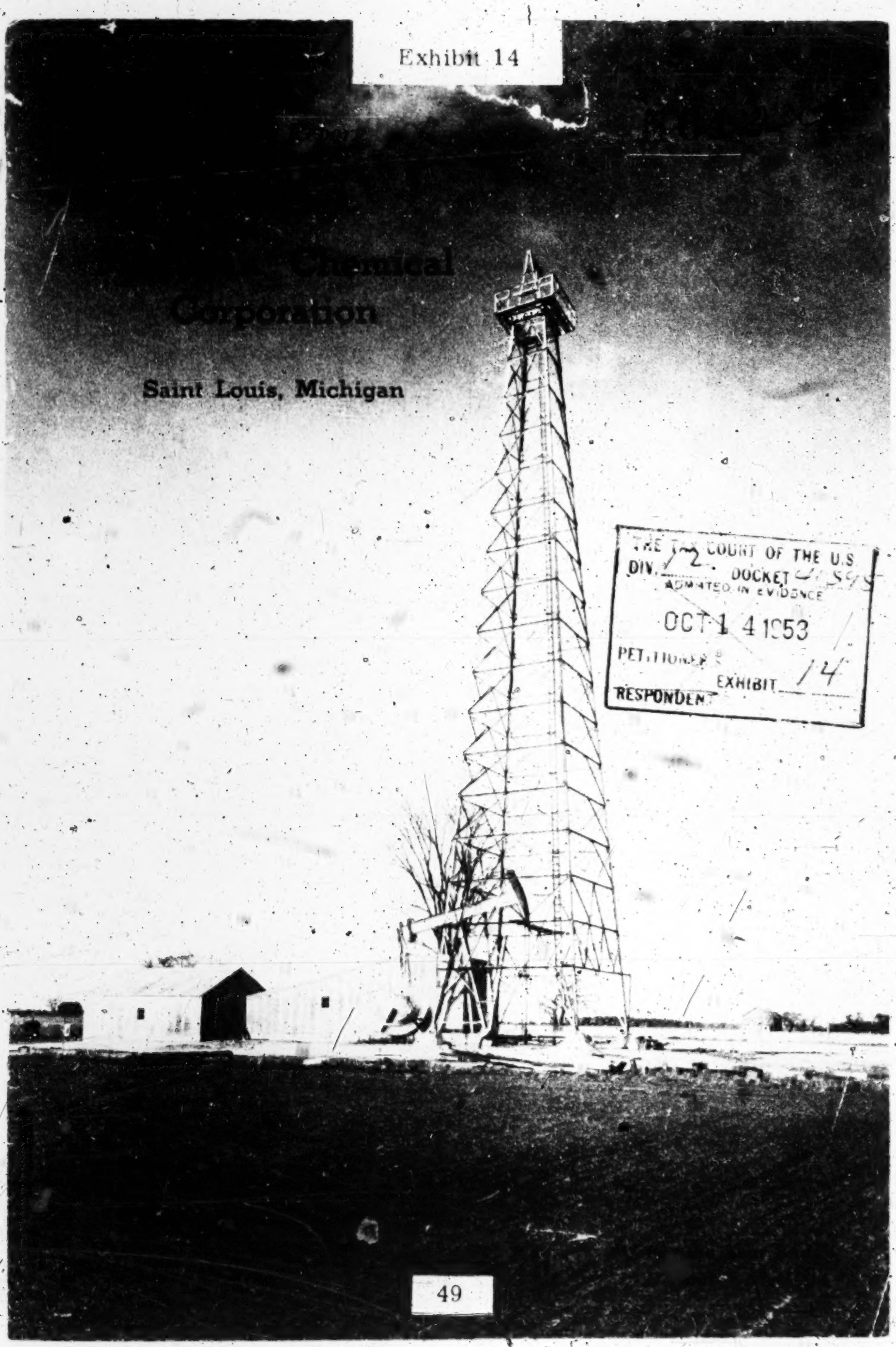
_____ (Name) _____ (Relationship)

_____ (Name) _____ (Relationship)

_____ (Name) _____ (Relationship)

_____ (Name) _____ (Relationship)

Exhibit 14



THE TAX COURT OF THE U.S.
DIV. 2 DOCKET 5575
ADMITTED IN EVIDENCE
OCT 1 4 1953
PETITIONER'S EXHIBIT 14
RESPONDENT

Officers and Directors

OFFICERS

W. T. MORRIS	*President*
T. C. DAVIS	*Executive Vice-President*
JOHN L. GILES	*Vice-President & General Manager*
ROBERT L. WILSON	*Secretary*
C. FRED MATGEN	*Treasurer*
RUSSELL J. KNAPP	*Assistant Treasurer*

DIRECTORS

T. C. DAVIS	W. T. MORRIS
JOHN L. GILES	R. HOWARD WEBSTER
C. N. JOHNS	ROBERT L. WILSON

TRANSFER AGENT

National Bank of Detroit
Detroit, Michigan

Saint Louis, Michigan
February 28, 1945

33.

To the Stockholders of
MICHIGAN CHEMICAL CORPORATION

Herewith is submitted the annual report for the Michigan Chemical Corporation. This report includes balance sheet as of December 31, 1944, profit and loss summary and a statement of surplus for the year as approved by the auditors, Ernst & Ernst.

You will note that net profit for the year, after all charges, amounted to $82,421, equivalent to 41c per share. This compares with a loss of $101,348 for 1943. There was an increase in the charge for depreciation of plants and facilities of approximately 33% over 1943. Although costs of maintenance and repairs were sharply higher for 1944, the physical condition of the entire plant shows marked improvement.

The mortgage loan was reduced from $457,772 as of December 31, 1943 to $354,307 on December 31, 1944, or an actual reduction of $103,465. Furthermore, $107,789 of this loan is scheduled for retirement through monthly payments during the year 1945. On the other hand, bank loans which stood at $100,000 on December 31, 1943, were increased to $150,000 and stood at $123,517 as of December 31, 1944. This loan is being retired through monthly payments and matures on August 7, 1945.

New plant facilities financed by your corporation were added during 1944. The major addition was the installation of facilities for production of dichlorodiphenyl-tricloroethane, commonly known as DDT. This is the new insecticide extensively used by U. S. Government agencies at present but which product has a most promising future as an insecticide for use post war.

During the year, options on 20,000 shares of stock at $5.00 a share were exercised, this being the last of the 100,000 shares so optioned. The entire purchase price accrued to the company.

Stockholders at the annual meeting held on March 21, 1944 approved the proposed action of the Board of Directors to set aside 15,000 of the authorized but unissued common stock of the corporation for sale to such key employees as determined by the Board of Directors and, as from time to time determined by said Board, during the next three years at $5.00 per share, being the approximate market value of said stock at that time. I am pleased to advise you that pursuant to action of stockholders, above referred to, and subject to requirements fixed by the Board, 8825 shares of the unissued stock of the corporation have been allotted to 38 key employees for purchase at $5.00 per share. This leaves a balance of 6175 shares of stock to be allotted as an incentive to key employees during the next two years.

During the year our technical and research departments were enlarged and strengthened. A number of additional products have been developed and will be added to our line during the coming year. Research work is just now being concentrated on broadening our line of insecticides, developing new products, and refining and improving the quality of existing products.

There was an increase of 40% in sales for 1944 over 1943 and there is every indication that a further substantial sales increase will be experienced during 1945. This will necessitate the continuance of our program of enlarging and improving our plant and facilities.

Your officers and directors are not unmindful of the many problems yet to be confronted in establishing and promoting the growth of your company. However, it is believed that the maintenance of conservative policies coupled with the continuing effort and team work of our loyal employees will assure the satisfactory solution of the problems yet before us.

By Order of the Board of Directors,

W. T. Morris, President.

Michigan Chemical Corporation

Balance Sheet, December, 31, 1944

ASSETS

CURRENT ASSETS			
Cash:			
On deposit and on hand		$ 87,281.93	
Cash collateral account—Note A		80,016.70	$ 167,298.63
Trade accounts receivable—Notes A and B		$195,667.93	
Less reserve		5,000.00	190,667.93
Inventories—at lower of cost (first-in, first-out method) or market—Note B:			
Finished products		$ 44,969.59	
Work in process		13,550.27	
Raw materials		89,672.41	148,192.27
TOTAL CURRENT ASSETS			$ 506,158.83
INVESTMENTS AND OTHER ASSETS			
Claim for refund on federal taxes on income of year 1941—estimated		$ 7,500.00	
Cash surrender value of life insurance—Note B		$5,550.00	
Equity in foreign enterprise		4,322.95	
Capital stock of Michigan Salt Company (100% owned)—at cost		1,000.00	
Deposits, advances, and miscellaneous accounts		2,320.43	20,693.38
PROPERTY, PLANT, AND EQUIPMENT at cost (including emergency facilities of $692,415.93), less reserves for depreciation and amortization—Note B			
Land			$ 14,345.45
Wells and reservoir	$ 251,116.77		
Buildings and other structures	174,566.31		
Machinery and equipment	936,800.43		
	$ 1,362,483.51		
Less reserves for depreciation (in-			

Equity in foreign enterprise		4,322.95	
Capital stock of Michigan Salt Company (100% owned)—at cost		1,000.00	
Deposits, advances, and miscellaneous accounts		2,320.43	20,693.38
PROPERTY, PLANT, AND EQUIPMENT			
at cost (including emergency facilities of $692,415.93), less reserves for depreciation and amortization—Note B			
Land		$ 14,345.45	
Wells and reservoir	$ 251,116.77		
Buildings and other structures	174,566.31		
Machinery and equipment	936,800.43		
	$ 1,362,483.51		
Less reserves for depreciation (including $223,488.75 for amortization of emergency facilities)	555,600.24	806,883.27	
Construction in progress		14,930.62	836,159.34
DEFERRED CHARGES			
Inventory of repair parts and supplies —Note B		$ 38,515.23	
Unexpired insurance premiums		11,164.91	49,680.
			$ 1,412,691.69

Note A—Notes payable represent bank loans in which Reconstruction Finance Corporation has a deferred two-thirds participation. The notes are payable in monthly installments with the balance maturing on August 7, 1945, and are secured by a general assignment of trade accounts receivable. Under terms of the loan agreement, collections on assigned accounts are deposited with the bank in a collateral account and are available to the Corporation on demand to the extent that such deposits, together with 80% of the accounts receivable, exceed the loans.

Board of Directors,
Michigan Chemical Corporation,
Saint Louis, Michigan

We have examined the balance sheet of Michigan Chemical Corporation as of December 31, 1944, and the statements of profit and loss and surplus for the year then ended, have reviewed the system of internal control and the accounting procedures of the Corporation and, without making a detailed audit of the transactions, have examined or tested accounting records of the Corporation and other supporting evidence by methods and to the extent we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circum-

Michigan Chemical Corporation

Balance Sheet, December 31, 1944

LIABILITIES

CURRENT LIABILITIES		
Notes payable—Note A		$ 123,517.03
Accounts payable:		
Trade accounts	$ 89,055.27	
Salaries, wages and commissions	18,924.16	
Payroll taxes and income taxes withheld from employees	12,302.47	
Employees' deposits for purchase of War Savings Bonds	2,976.36	
Employees' compensation claims	1,632.90	124.891.16
Accrued expenses		3,300.59
Payments due on mortgage loan prior to January 1, 1946		107,789.60
TOTAL CURRENT LIABILITIES		$ 359,498.38
MORTGAGE LOAN—Note B		
From Reconstruction Finance Corporation, payable in monthly installments with interest at 4% per annum	$354,306.97	
Less payments due prior to January 1, 1946, included in current liabilities	107,789.60	246,517.37
CAPITAL STOCK AND SURPLUS—Notes B and C		
Common stock, par value $1.00 per share:		
Authorized 250,000 shares		
Unissued (of which 27,789 shares are reserved) 50,226½ shares		
Issued and outstanding 199,773½ shares	$199,773.50	
Capital surplus	566,981.95	
Earned surplus	39,920.49	806,675.94

Note B—The mortgage loan is secured by a mortgage on all real and personal property of the Corporation, by an assignment of a life insurance policy, and by an assignment of trade accounts receivable, subject to the assignment of such accounts as set forth in Note A above. Under the terms of the mortgage loan

Michigan Chemical Corporation

Year ended December 31, 1944

PROFIT AND LOSS SUMMARY

Sales, less cost of products sold		$268,800.15
Expenses:		
Selling and advertising	$ 93,496.23	
Administrative and general	73,264.66	166,760.89
		$102,039.26
Miscellaneous income		713.88
		$102,753.14
Interest expense		20,331.72
		$ 82,421.42
Federal taxes on income:		
Normal tax and surtax amounting to $35,000.00 on income of the year is eliminated by credit resulting from carry-over of net operating losses of preceding two years		-0-
NET PROFIT		$ 82,421.42
Costs and expenses for the year include:		
Provision for depreciation of property, plant and equipment	$ 64,257.71	
Amortization of emergency facilities	131,236.83	
TOTAL		$195,494.54

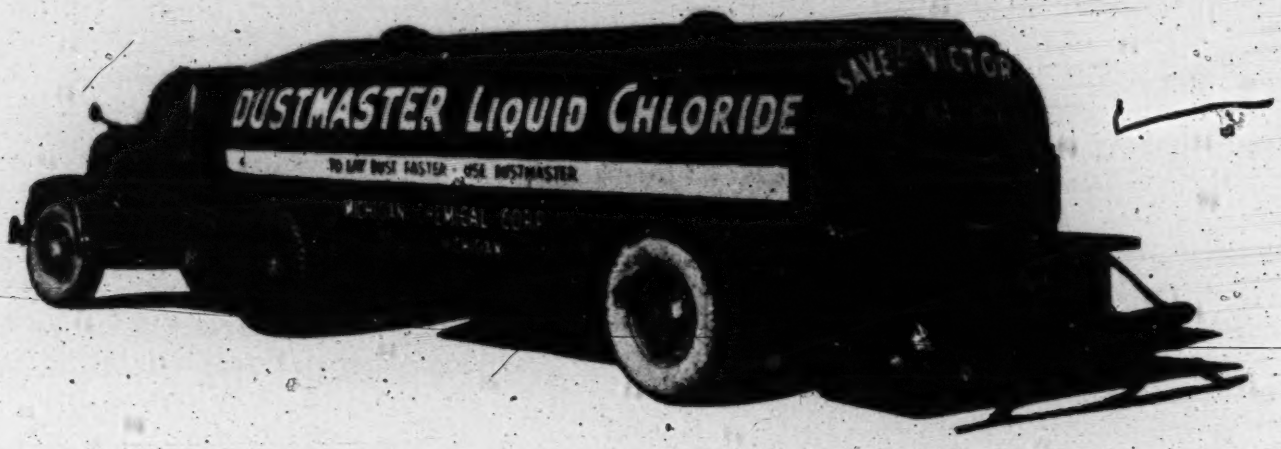
Note A—Certain sales for the year are subject to the Renegotiation Act which requires refund of profits found to be excessive; however, profits on such sales for the year are considered to be not excessive and no provision for refund is believed to be required. No refunds were required for prior years.

DUST MASTER

37

LIQUID CALCIUM MAGNESIUM CHLORIDE

(40% Solution)



The most important use of this material is for the elimination of dust and to consolidate the surfaces of gravel, crushed stone and cinder roads and streets. Delivery is made in tank cars; also in tank trucks, including the work of spreading the liquid on roads.

As an anti-freeze treatment for coal, to facilitate the unloading of cars of washed coal that are shipped during cold weather, liquid Calcium Magnesium chloride has met with increased acceptance by coal mining companies. It also has value in the elimination of dust from coal.

As liquid ballast in farm tractor tires, this material has extensive use because of its low freezing point and its heavy weight per gallon. Tires are filled three-quarters full of the solution, to give increased traction and better riding qualities in tractor operation.



Kent County road near Cedar Springs, Michigan. This county, noted for its progressive road maintenance methods, has used liquid chloride for the past several years.

BROMIDES

38

INORGANIC

*Aluminum Bromide
Ammonium Bromide, N.F. VII
Barium Bromide
Bromine, USP XII
Calcium Bromide, USP XII
Ferrous Bromide
Hydrobromic Acid, USP
*Lithium Bromide
Phosphorus Tribromide
Potassium Bromide, USP XII
Sodium Bromide, USP XII
Strontium Bromide, N.F. VII

The major uses of these Inorganic Bromide Compounds are in Organic Synthesis, Dye Intermediates, Pharmaceuticals, Analytical Chemistry, Photography, Process Engraving, Lithography, and Brominating Agents. These are only a few of the many uses for these products.

ORGANIC

Allyl Bromide
*n-Amyl Bromide
Bromoform
Butyl Bromide
Dibromofluorescein
Ethyl Bromide
*Ethylene Dibromide
*n-Hexyl Bromide
*Merbromin
Methyl Bromide
*Pentabromoethane
*Monobrominated Camphor
*Tetrabromoethane
*Tetrabromoethylene
*Tribromophenol
*Tribromoethylene
*Tribromo-t-butyl Alcohol

These organic bromides are used as sedatives, the manufacture of synthetic perfumes, manufacture of symsetized paper, organic synthesis, manufacture of dyes and pharmaceuticals, refrigerants, fumigants and many other uses.

SODIUM CHLORIDE, U.S.P., C.P.—Used in medicinal sprays and fluids, as a source of chlorine, sodium and their compounds, dyeing of fabrics, ceramics, glass, food preservatives, analytical chemistry, fertilizers and paper.

METHYL BROMIDE in government tests has been proven to be probably the most efficient fire depressant, especially for oil fires. Light weight apparatus required for its use indicates early adoption for airplanes. Your company is prepared to meet this demand.

(* Available in research quantities only).

MAGNESIUM OXIDES

Calcined Magnesite:

Designated as Michigan No. 1 and No. 5.

Michigan No. 1—Hard burned heavy magnesite, minimum purity 97% Magnesium Oxide.

Michigan No. 5—Soft burned light magnesite, minimum purity 97% Magnesium Oxide.

Uses:

Manufacture of glue, rayon, metallic magnesium, epsom salts, tartaric acid, refractories, fertilizers, magnesium carbonate and other chemicals. Also used as a catalyst in the production of synthetic rubber ingredient.

Calcined Magnesia:

Designated as Michigan No. 15, No. 25 and No. 30.

Uses:

Michigan No. 15—a heavy magnesia made by controlling conditions of burning to make it suitable for compounding certain grades of rubber, particularly hard rubber goods.

Michigan No. 25 and No. 30—light weight finely divided powders used principally for compounding with Neoprene (an oil resistant synthetic rubber). Neoprene compounds are used in insulating wire and cables, mechanical goods, in diaphrams, gaskets, pump valves, gasoline and oil hose, rubber gloves, rubber thread (latex). In War Effort Neoprene compounds are used in self-sealing gas tanks, life rafts, life preservers, gas hose and insulation for electric cables.

MICHIGAN SALT CO.

Sales Affilliate of
Michigan Chemical Corp.

The Dealer and Distributor organization of the Michigan Salt Company continues to grow as evidence of consumer recognition of the High Quality maintained under the three popular brands, Crystal Flow, Gold Medal and Red Bag.

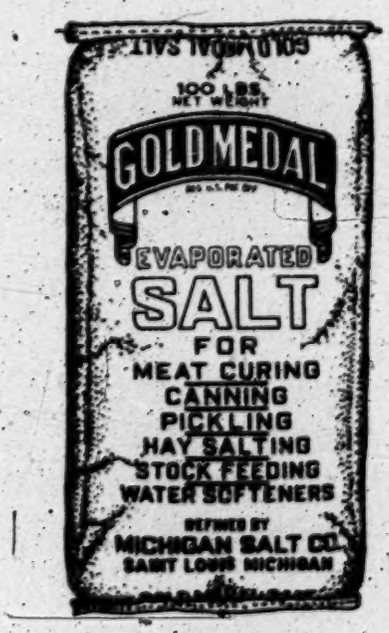
Labor-saving equipment was added during the year for packing salt in modern multiwall moisture-proof paper bags. Experienced supervision insures uninterrupted operations, uniform quality and better service.

HIGH GRADE TABLE SALT

NON-HARDENING SALT **KILN DRIED SALT**

COMPRESSED SALT BLOCKS







CAPITAL STOCK AND SURPLUS - Notes B and C

Common stock, par value $1.00 per share:		
Authorized 250,000 shares		
Unissued (of which 27,789 shares are reserved)		
50,226½ shares		
Issued and outstanding 199,773½ shares	$199,773.50	
Capital surplus	566,981.95	
Earned surplus	39,920.49	806,675.94
		$1,412,691.69

Note B—The mortgage loan is secured by a mortgage on all real and personal property of the Corporation, by an assignment of a life insurance policy, and by an assignment of trade accounts receivable, subject to the assignment of such accounts as set forth in Note A above. Under the terms of the mortgage loan agreement, the Corporation has agreed, among other covenants, that it will not, without prior consent of Reconstruction Finance Corporation, make any distribution upon its capital stock, or purchase or retire any of its capital stock. In addition to fixed monthly payments of $10,000 each, including interest, the Corporation is required to make additional payments on principal on March 1st of each year in the amount by which fifty per cent of net earnings before depreciation for the preceding year exceeds the aggregate monthly amounts paid on principal in such year. Reconstruction Finance Corporation has waived the payment which would have been due under this provision on March 1, 1945.

Note C—At December 31, 27,789 shares of unissued common stock are reserved, as follows:

For issuance upon sale to management and key employees of the Corporation at $5.00 per share on or before March 21, 1947	15,000	shares
For exercise of outstanding purchase warrants at $5.00 per share on or before March 1, 1947	8,750	
For exercise of purchase options at $15.00 per share on or before June 30, 1945	4,039	
TOTAL	27,789	shares

stances and included all procedures which we considered necessary. It was not practicable to confirm by direct communication the account receivable from a United States Government department, but we satisfied ourselves as to such account by means of other auditing procedures.

In our opinion, the accompanying balance sheet and related summary of profit and loss and statement of surplus present fairly the position of Michigan Chemical Corporation at December 31, 1944, and the results of its operations for the year, in conformity with generally accepted accounting principles, applied on a basis consistent with that of the preceding year.

February 28, 1945
Grand Rapids, Mich.

ERNST & ERNST,
Certified Public Accountants

ceding two years ....

NET PROFIT	$ 82,421.42

Costs and expenses for the year include:

Provision for depreciation of property, plant and equipment	$ 64,257.71
Amortization of emergency facilities	131,236.83
TOTAL	$195,494.54

Note A—Certain sales for the year are subject to the Renegotiation Act which requires refund of profits found to be excessive; however, profits on such sales for the year are considered to be not excessive and no provision for refund is believed to be required. No refunds were required for prior years.

STATEMENT OF SURPLUS

Capital surplus:

Balance at January 1, 1944	$486,981.95
Excess of selling price over par value of 20,000 shares of common stock issued during the year	80,000.00
Balance at December 31, 1944	$566,981.95

Earned surplus:

Deficit* at January 1, 1944	$ 42,500.93*
Net profit for the year	82,421.42
Balance at December 31, 1944	$ 39,920.49

Note A—See Note B to balance sheet respecting restriction on payment of dividends.

DDT . . . A Big Step Forward

In April, 1944, it was determined that your Company should produce DDT. During the last week of August, 1944, the first shipment of DDT was made to the Quartermaster Corps of the United States Army. Thus in five months, through the driving efforts of almost the entire organization a job was done which would normally require from six months to a year for the research and pilot work alone.

DDT (Dichloro-diphenyl-trichloroethane) controls a larger variety of insects than any other insecticide now known. Reports from the Office of Surgeon General stated that "DDT will be to preventive medicine what Lister's discovery of antiseptics was to surgery." It has sometimes been referred to as "The penicillin of the insecticides."

DDT is not a kill-all, and has its limitations. However, its proven use and investigations of its possible uses now clearly indicates that this product is destined to be most important in the field of insecticides. Probable post-war users of DDT will include the housewives, innkeepers, storekeepers, farmers, cattlemen, dairymen, orchardists, dry cleaners, paint manufacturers, forest and land conservation groups, and many others. Properly used, DDT could revolutionize the methods of controlling household and agricultural insects in this country.

Your company's research has also, during the past year, developed new insecticidal products and formulas which are now undergoing tests.

Dessicants . . .

A dessicant capsule has been developed for use in shipping containers of materials effected by small amounts of moisture in the containers. The capsules are plastic and a convenient size to use in small shipping containers.

Research . . .

During the year our research staff completed work on a number of new products. Success of our staff warrants the early construction of enlarged research facilities. Furthermore, it will be necessary during the coming year to add to our plant capacities in order to supply the products developed.

Exhibit 15

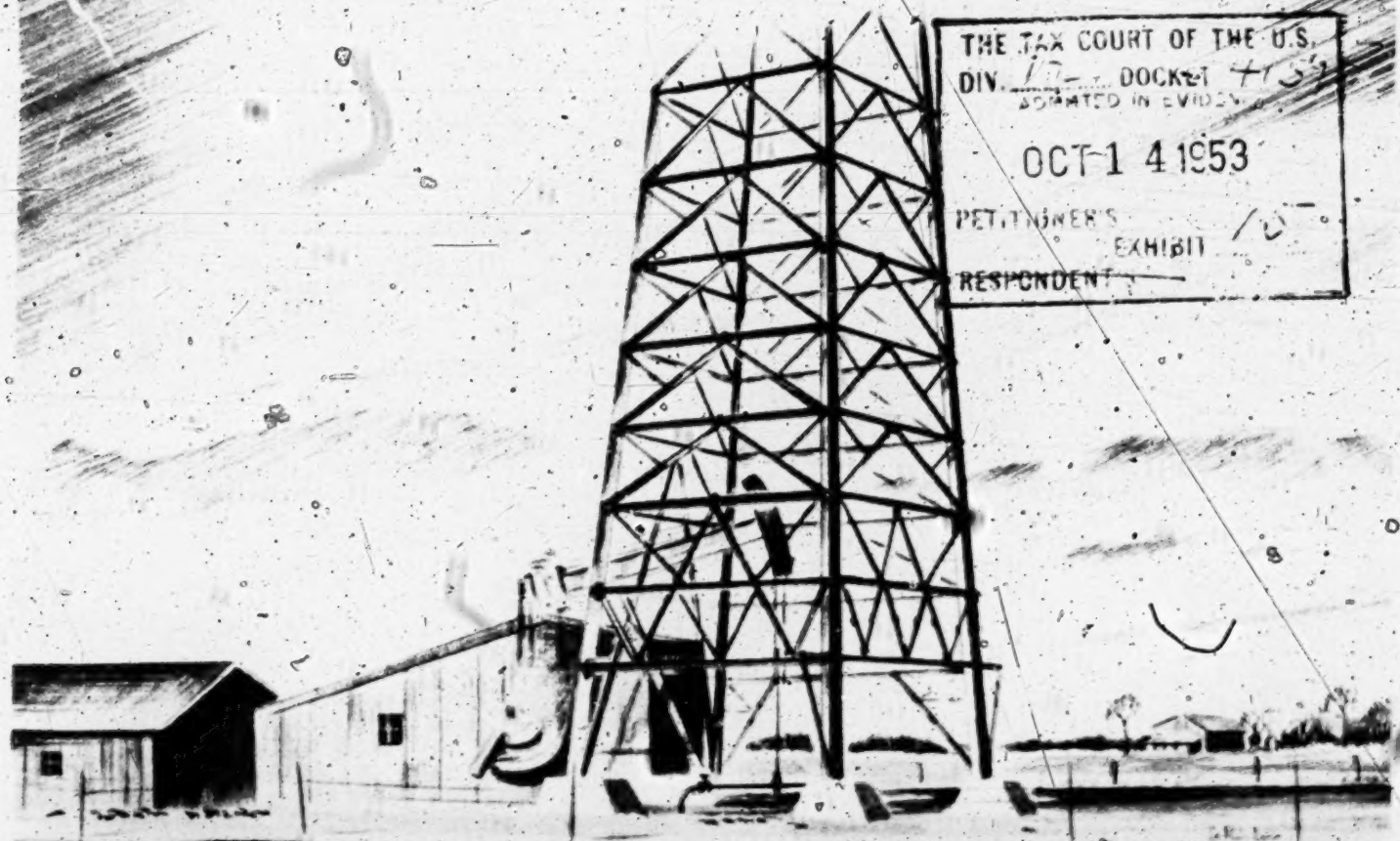
Annual Report
For the Year Ended
December 31, 1945



Michigan
CHEMICAL CORPORATION

pharmaceutical · industrial
insecticidal chemicals

THE TAX COURT OF THE U.S.
DIV. 12 DOCKET 4753
ADMITTED IN EVIDENCE
OCT 1 4 1953
PETITIONER'S EXHIBIT 12
RESPONDENT



MICHIGAN CHEMICAL CORPORATION · SAINT LOUIS, MICHIGAN

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CORPORATION, SAINT LOUIS, MICHIGAN

FOREWORD



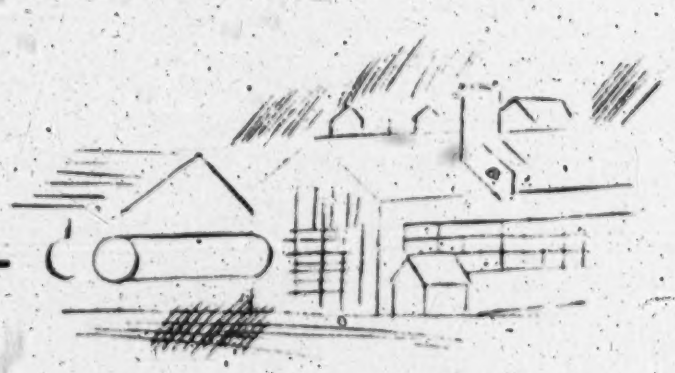
MICHIGAN CHEMICAL CORPORATION presents in the following pages technical data and a brief outline of the uses of its pharmaceutical, industrial and insecticidal chemicals produced in its modern plant at Saint Louis, Michigan, which is located in the heart of a district rich in natural mineral deposits.

From its own wells, which dot the countryside for miles around Saint Louis, Michigan Chemical Corporation produces the brine which is abundant in the basic minerals used in the manufacture of its many fine chemicals.

Each year has seen the addition of new plant facilities required to keep pace with growing production activity, necessitated by increased demand for our products and the addition of new items. Most recent of these are Dichloro-diphenyl-trichloroethane (DDT), and new metal and organic bromides. Other new and important chemicals now in the process of devolopment will meet the most advanced needs of the chemical, pharmaceutical, and other manufacturers, and will be announced from time to time.

Recognized throughout the world as a producer of uniformly fine quality products, Michigan Chemical Corporation with its staff of technical experts, abundant sources of raw material and production facilities will take an ever-increasingly important part in the chemical era we are now entering.

MICHIGAN CHEMICAL CORPORATION



MICHIGAN CHEMICAL CORPORATION

SAINT LOUIS, MICHIGAN

ALLYL BROMIDE

GENERAL PROPERTIES:

Colorless to slightly yellowish clear liquid with unpleasant, pungent odor. POISONOUS.

PHYSICAL DATA:

Chemical Symbol CH_2:CH.CH_2Br. Molecular wt. 120.96. Bromine, 66.1%. Slightly soluble in water; miscible with alcohol, chloroform, ether, carbon disulfide. Must be kept tightly sealed. Specific Gravity 1.4; boils 70-71°C.

USES:

The manufacture of synthetic perfumes, intermediates, and other allyl compounds.

GRADE PRODUCED: Technical

SHIPPING REGULATIONS:

Poison and Inflammable Label required.

PACKING:

5-gal. Carboys (50 lbs.), 13-gal. Carboys (140 lbs.).

PHYSICAL DATA:

Chemical Symbol CH_2:CH.CH_2Br. Molecular wt. 120.96. Bromine, 66.1%. Slightly soluble in water; miscible with alcohol, chloroform, ether, carbon disulfide. Must be kept tightly sealed. Specific Gravity 1.4; boils 70-71°C.

USES:

The manufacture of synthetic perfumes, intermediates, and other allyl compounds.

GRADE PRODUCED: Technical

SHIPPING REGULATIONS:

Poison and Inflammable Label required.

PACKING:

5-gal. Carboys (50 lbs.), 13-gal. Carboys (140 lbs.).

ALUMINUM BROMIDE ANHYDROUS

GENERAL PROPERTIES:

White to yellowish-red very hygroscopic lumps or powder which fumes strongly on exposure to air. Reacts violently, explosively with water. Poisonous.

PHYSICAL DATA:

Chemical Symbol $AlBr_3$. Molecular weight 266.72. Specific gravity 3.0. Melting point 93°. Boiling point 268°. Decomposes water and alcohol. Very soluble in benzene, toluene, xylene, other hydrocarbons and organic solvents. Must be kept in tightly closed containers.

USES:
Laboratory reagent, preparation of organic compounds, as a catalyst.

GRADE: Technical.

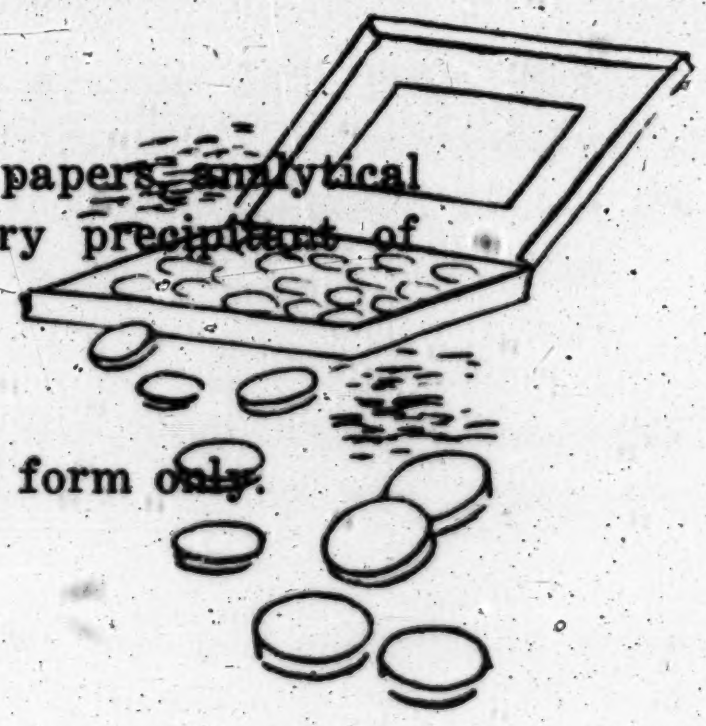
AMMONIUM BROMIDE

GENERAL PROPERTIES:
White, odorless, slightly hygroscopic granules or powder; pungent, saline taste; sublimes at high temperature without melting and slowly turns yellowish when exposed to air.

PHYSICAL DATA:
Chemical Symbol, NH_4Br. NH, 17.39%; Br 81.58%. Molecular wt. 97.96. Specific gravity 2.55. pH 4.6. One gram dissolves in 1.3 cc water, 0.9 cc boiling water, 12 cc alcohol, 1.2 cc boiling alcohol, in about 30 cc anhydrous alcohol. Should be kept tightly closed.

USES: Medicinal
Used in treatment of epilepsy, delirium tremens, nervous headaches, seasickness, chronic bronchitis and as nerve sedative. More irritating than Potassium Bromide.

Industrial
Used in the manufacture of photographic films, plates and papers; analytical chemistry, process engraving and lithographing; laboratory precipitant of silver salts.



GRADE PRODUCED: N.F. VII
Ammonium Bromide is available in Granular and Powdered form only.

SHIPPING REGULATIONS:
In glass, crated or boxed.

PACKING:

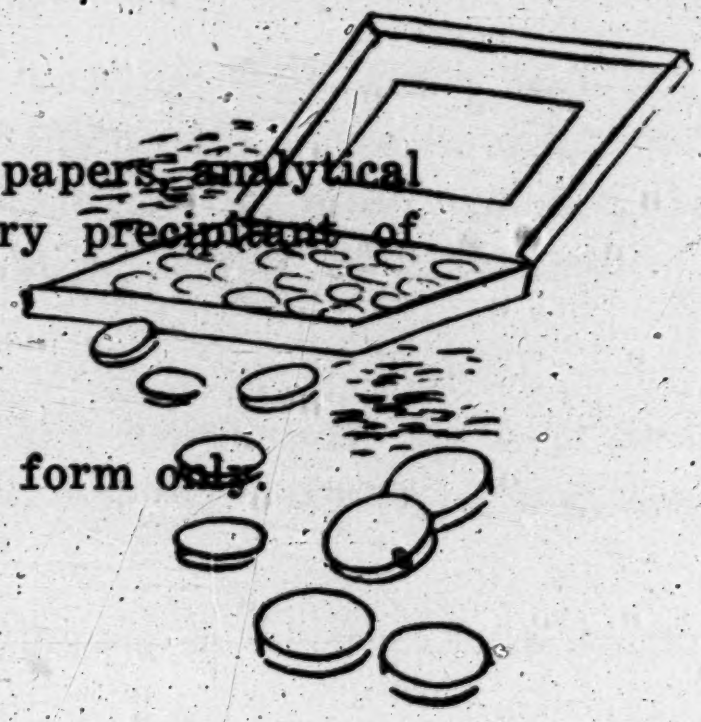
Should be kept tightly closed.

USES: Medicinal

Used in treatment of epilepsy, delirium tremens, nervous headaches, seasickness, chronic bronchitis and as nerve sedative. More irritating than Potassium Bromide.

Industrial

Used in the manufacture of photographic films, plates and papers, analytical chemistry, process engraving and lithographing; laboratory precipitant of silver salts.



GRADE PRODUCED: N.F. VII

Ammonium Bromide is available in Granular and Powdered form only.

SHIPPING REGULATIONS:

In glass, crated or boxed.

PACKING:

25-lb. Drums, 100-lb. Drums, 300-lb. Barrels.

BARIUM BROMIDE

GENERAL PROPERTIES:

Colorless, odorless white granules or powder. POISONOUS.

PHYSICAL DATA:

Chemical Symbol $BaBr_2.2H_2O$. Ba. 41.22%; Br. 47.97%; H_2O 10.81%. Molecular weight 333.2. Specific gravity 3.852. Soluble in water, 1 gm. dissolves

in 1 cc water, 0.7 cc boiling water. Melts 880° C. pH 6-7. Soluble in alcohol and methanol. Contains 89.2% anhydrous $BaBr_2$.

USES:

Manufacture of alkaloid hydrobromides.

GRADE PRODUCED: Purified.

SHIPPING REGULATIONS: None.

PACKING:

25-lb. Drums, 150-lb. Drums.

LIQUID BROMINE

GENERAL PROPERTIES:

Dark reddish-brown, fuming, volatile liquid; suffocating odor; fumes are highly irritating to eyes and lungs. Burns and blisters the skin. Attacks all metals and organic tissues and may produce fire on contact with sawdust, excelsior, etc. Must be kept sealed in glass or earthenware containers and when handling always keep ammonia within reach.

PHYSICAL DATA:

Chemical Symbol Br. Atomic wt. 79.92. Specific gravity 3.12. Boils 58.7° C, but rapidly vaporizes at room temperature. Solidifies –7°C. One cc dissolves in about 30 cc water; freely soluble in alcohol, chloroform, ether, carbon disulfide, carbon tetrachloride, concentrated HCl, in aq. solns. of bromides.

USES: Medicinal

Alterative, caustic, antiseptic, disinfectant in the treatment of laryngeal diphtheria, membranous croup, bronchocele, scrofulous tumors, gangrene, etc.

BROMOFORM

GENERAL PROPERTIES:

Water-white heavy liquid, sweet odor and taste similar to that of chloroform. When exposed to light and air it gradually assumes yellowish color and decomposes. Should be kept in well sealed containers, protected from access of light and air.

PHYSICAL DATA:

Chemical Symbol $CHBr_3$. Bromine 94.85%. Molecular wt. 252.76. Specific gravity 2.59-2.62 (with preservative), m.p. 9°C. B.p. 149°-150°. Soluble in alcohol, ether, chloroform, benzene, fixed and volatile oils, slightly soluble in water. Pure bromoform is preserved by the addition of four percent ethyl alcohol.

USES: Medicinal

Antispasmodic, sedative, seasickness and whooping cough.

Industrial

Geological assaying, intermediate in organic syntheses, liquid for pressure gauges and where a high gravity liquid is required.

GRADE PRODUCED: U.S.P. IX.

SHIPPING REGULATIONS:

Railroad shipping regulations: None.
Steamship regulations: On deck storage.

PACKING:

5-lb. Bottles packed 10 to the wooden case, 5-gal. Carboys (100 lbs.)

Power Plant and Salt Plant at left, Organic Bromide at right, and Bromine Plant.



GRADE PRODUCED: U.S.P. XI.

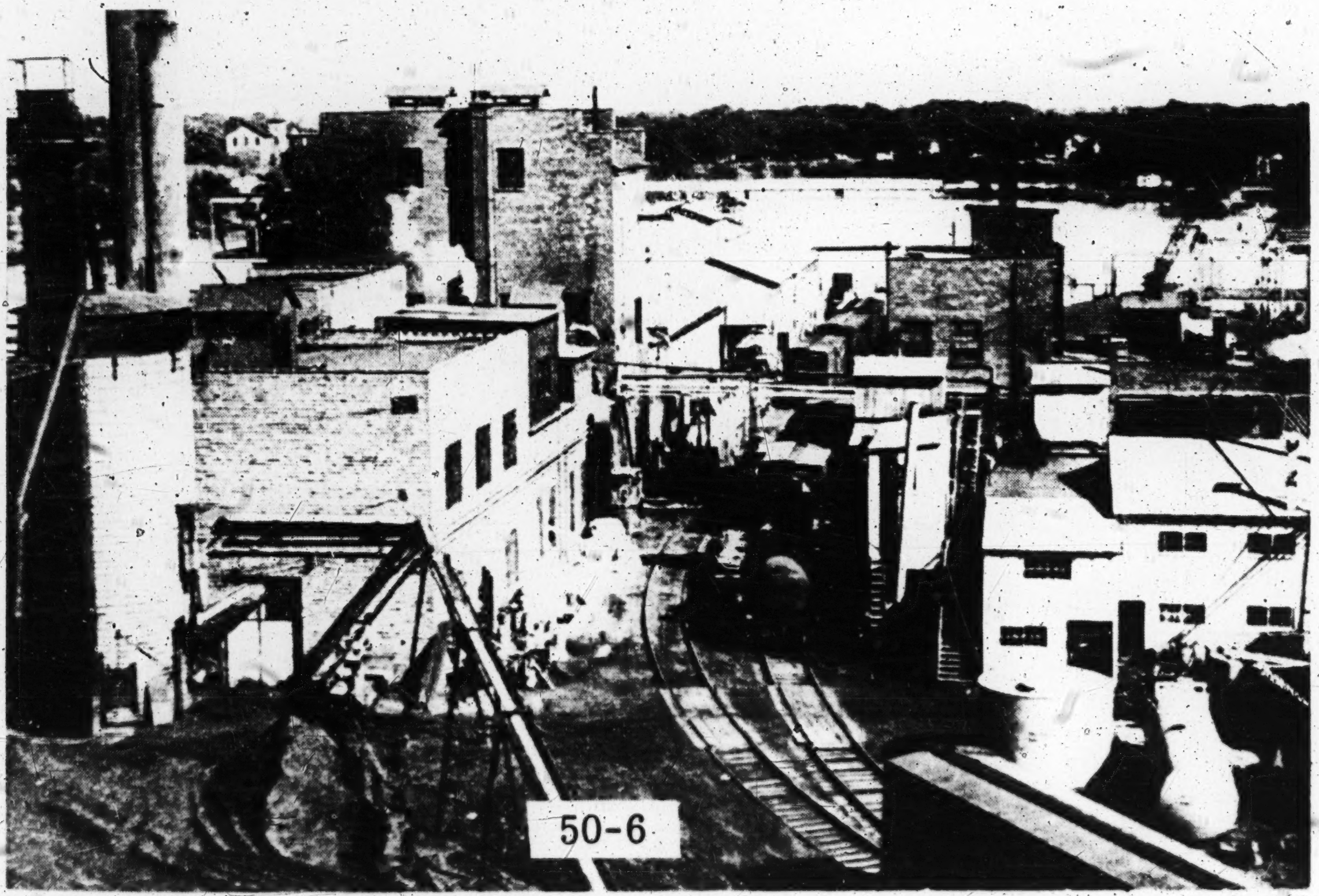
SHIPPING REGULATIONS:

Railroad shipping regulations: None.
Steamship regulations: On deck storage.

PACKING:

5-lb. Bottles packed 10 to the wooden case, 5-gal. Carboys (100 lbs.)

Power Plant and Salt Plant at left, Organic Bromide at right, and Bromine Plant.



N-BUTYL BROMIDE

GENERAL PROPERTIES:
Colorless, inflammable liquid with a characteristic odor. Turns yellowish when exposed to light or air.

PHYSICAL DATA:
Chemical Symbol n-CH_3 CH_2 CH_2 CH_2 Br. Molecular Weight, 136.99. Bromine 58.34%. Specific gravity 1.275; weight per gallon 10.5 lbs. Boiling point 99-101.5°. Insoluble in water, soluble in alcohol, ether.

USES:
As an intermediate in preparation of pharmaceuticals, organic chemicals.

GRADE PRODUCED: Technical.

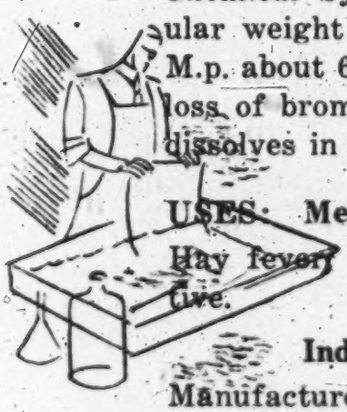
SHIPPING REGULATIONS: None.

PACKING:
5-gal. Carboys (50 lbs.), 13-gal. Carboys (130 lbs.), Steel Drums (500 lbs.)

CALCIUM BROMIDE

GENERAL PROPERTIES:
White powder, very deliquescent crystals, odorless, sharp, saline taste. Becomes yellow on long exposure to air.

PHYSICAL DATA:
Chemical Symbol $CaBr_2.2H_2O$. Ca 16.99%, Br 67.74%, H_2O 15.27%. Molecular weight 235.94. Contains 84.73% anhydrous salt. Specific gravity 3.353. M.p. about 680° to 760°C. When well heated in air it becomes alkaline due to loss of bromine and formation of lime. Soluble in water and alcohol; 1 gm. dissolves in 0.7 cc cold, 0.4 cc boiling water, 1.3 cc alcohol.



USES: Medicinal
Hay fever, insomnia, tetanus, neuralgia, hysteria, epilepsy and nerve sedative.

Industrial
Manufacture of mineral waters, in photography for making dry plates and light-sensitive papers, drying and dehydrating agent.

GRADE PRODUCED: N. F. VII

SHIPPING REGULATIONS: None.

PACKING:
40-lb. Glass Jars.

50-7

Dark reddish-brown, fuming, volatile liquid; suffocating odor; fumes are highly irritating to eyes and lungs. Burns and blisters the skin. Attacks all metals and organic tissues and may produce fire on contact with sawdust, excelsior, etc. Must be kept sealed in glass or earthenware containers and when handling always keep ammonia within reach.

PHYSICAL DATA:

Chemical Symbol Br. Atomic wt. 79.92. Specific gravity 3.12. Boils 58.7° C, but rapidly vaporizes at room temperature. Solidifies –7°C. One cc dissolves in about 30 cc water; freely soluble in alcohol, chloroform, ether, carbon disulfide, carbon tetrachloride, concentrated HCl, in aq. solns. of bromides.



USES: Medicinal

Alterative, caustic, antiseptic, disinfectant in the treatment of laryngeal diphtheria, membranous croup, bronchocele, scrofulous tumors, gangrene, etc.

Incompatible with alkali hydroxides, arsenites, ferrous and mercurous salts, hypophosphites and other oxidizable substances.

Industrial

For dye intermediates, military gas, for gold extraction, bleaching fibers and silks, manufacture of medicinal bromide compounds, leather tanning, analytical reagent, inks, antiknock for gasoline, disinfectant and general oxidizing agent.

GRADE PRODUCED: U.S.P. XII

SHIPPING REGULATIONS:

White Label. 1-qt. limit—Express. Wooden Boxes with Glass Inside Containers not over 1 qt. each. See ICC 4.

PACKING:

6½ lb. Bottles packed 9 to the wooden case.



DUST MASTER

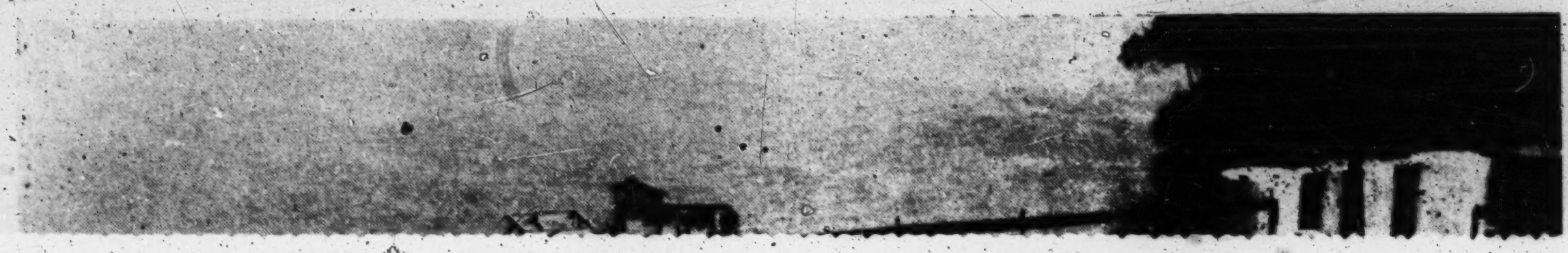
LIQUID CALCIUM MAGNESIUM (40% SOLUTION)

The most important use of this material is for the elimination of dust and to consolidate the surface of gravel, crushed stone and cinder roads and streets. Delivery is made in tank cars; also in tank trucks, including the work of spreading the liquid on roads.

As an anti-freeze treatment for coal, to facilitate the unloading of cars of washed coal that are shipped during cold weather, liquid Calcium Magnesium chloride has met with increased acceptance by coal mining companies. It also has value in the elimination of dust from coal.

As liquid ballast in farm tractor tires, this material has extensive use because of its low freezing point and its heavy weight per gallon. Tires are filled three-quarters full of the solution, to give increased traction and better riding qualities in tractor operation.

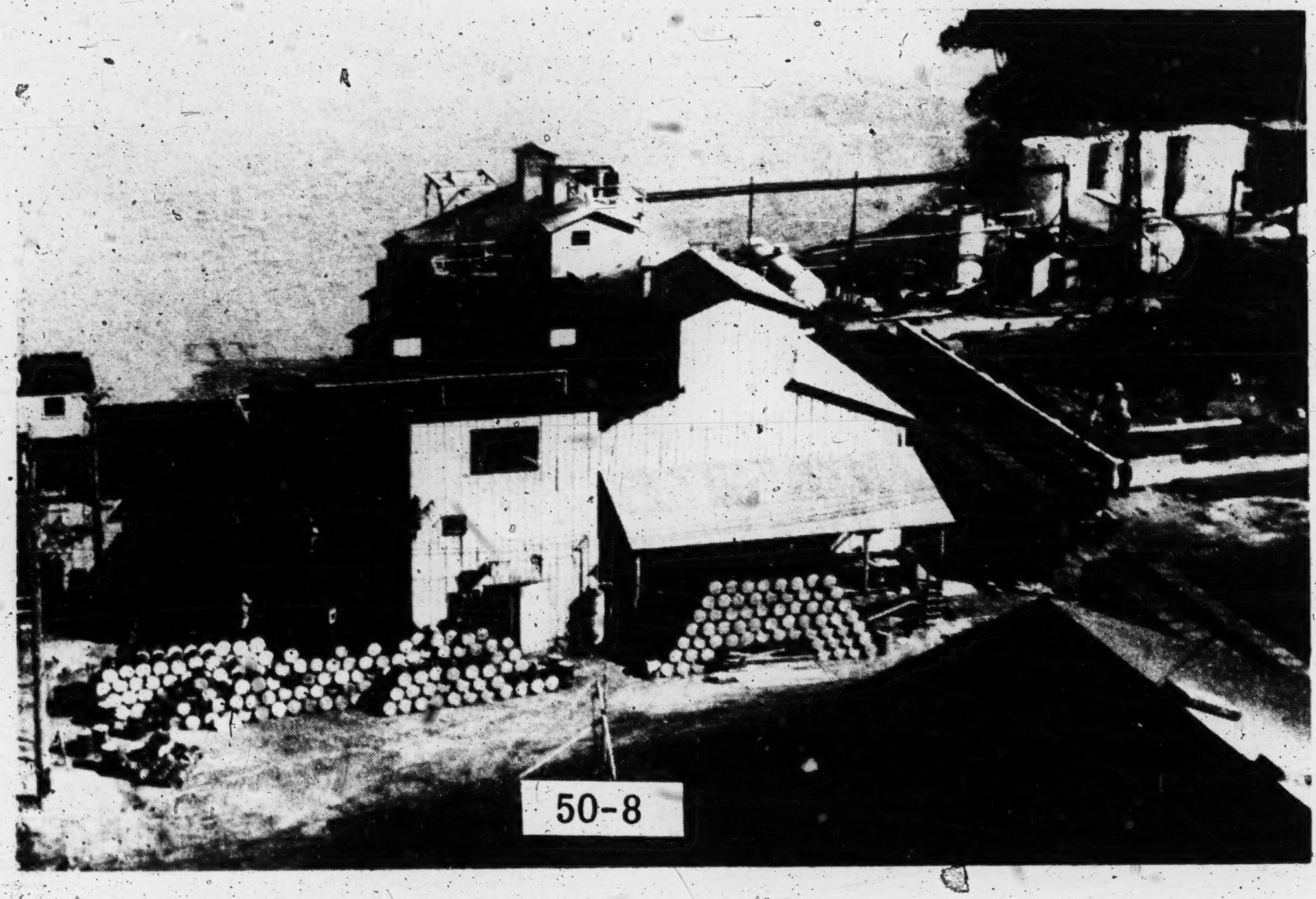
General view of our DDT plant showing storage tanks and shipping docks.



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General view of our DDT plant showing storage tanks and shipping docks.



DICHLORO-DIPHENYL-TRICHLOROETHANE (DDT) TECHNICAL

GENERAL PROPERTIES:

White, waxy solid having slightly fruity odor and consisting essentially of 1-trichloro-2,2-bis (p-chlorophenyl) ethane, lesser amounts of other isomers, and the by-products of reaction.

PHYSICAL DATA:

The melting point of this isomer mixture is not sharply defined so to establish a basis of product quality a minimum "setting point" of 89° C. has been established, and the technical term of "DDT" adopted which when used is interpreted as:

DDT—Technical (Setting Point 89° C. Minimum)
with the following physical properties:

Setting Point	89°-92° C.
(As defined in JAN-D-56A, Army 4-1122A and Navy 51-D-14A, specifications)	
pH	5.0 – 8.0
Ash	Less than 0.5%
Water-insoluble—steam volatile material	Less than 0.5%
Chloral hydrate	Less than 0.025%
Water soluble material	Less than 0.25%

Solubility in 100 g. Solvent at 20° C.

Absolute alcohol	More than 6 g.
Carbon tetrachloride	" " 20 g.
Chlorobenzene	" " 57 g.
Kerosene	" " 9 g.

USES:

Setting Point 89°-92° C.
(As defined in JAN-D-56A, Army 4-1122A and Navy 51-D-14A, specifications)
pH 5.0 – 8.0
Ash Less than 0.5%
Water-insoluble—steam volatile material Less than 0.5%
Chloral hydrate Less than 0.025%
Water soluble material Less than 0.25%
Solubility in 100 g. Solvent at 20° C.
Absolute alcohol More than 6 g.
Carbon tetrachloride " " 20 g.
Chlorobenzene " " 57 g.
Kerosene " " 9 g.

USES:

As the killing agent in finished insecticides both liquid and dust or powder form. Toxic to humans and some animals. Must be prepared and used as an insecticide with full knowledge of its effect on all forms of life, including plants.

GRADE PRODUCED: Technical.

SHIPPING REGULATIONS: None.

PACKING:

25-lb. Drums, 100-lb. Drums, 300-lb. Barrels.

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PESTMASTER
WITH DDT

The registered trade name applying to DDT concentrates and the various finished compositions containing DDT.

Correct formulations properly prepared from scientific research and actual tests in cooperation with Federal and State entomologists are offered.

For Household Use:

5% DDT Residual Spray
10% DDT Insecticidal Powder
10% DDT Wettable Powder
27½% DDT Emulsifiable Oil Concentrate for Dilution with water

For Agricultural and Industrial Use:

5% DDT Residual Spray
25% DDT and 27½% DDT Emulsifiable Oil Concentrate for Dilution with Water
50% DDT Dust
25% and 50% DDT Wettable Powder
3% DDT Fruit and Vegetable Dust

Various percentages of DDT and copper for use as an insecticide and fungicide.



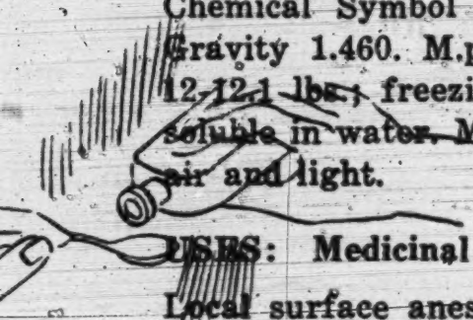
ETHYL BROMIDE

GENERAL PROPERTIES:

Colorless, volatile liquid; ethereal odor; burning taste; turns to yellowish color when exposed to air.

PHYSICAL DATA:

Chemical Symbol C_2H_5Br. Bromine 73.35%. Molecular wt. 108.96. Specific Gravity 1.460. M.p. –125°C. Boiling point 38.4°C. Weight per U.S. gallon 12.12.1 lbs.; freezing point –119°C; soluble in alcohol and ether; sparingly soluble in water. Must be kept tightly closed, in a cool place, protected from air and light.



USES: Medicinal

Local surface anesthetic. Spray in neuralgia and minor surgery. Internally for cardialgia, angina pectoris, etc.

Industrial

Refrigerant. An ethylating agent in the synthesis of many organic chemicals; in the production of dyes and pharmaceuticals, perfumes.

GRADES PRODUCED: Technical and Pure.

SHIPPING REGULATIONS: None.

PACKING:

5-gal. Carboys (55 lbs.), 13-gal. Carboys (140 lbs.), Steel Drums (600 lbs.)

FERROUS BROMIDE 50% SOLUTION

GENERAL PROPERTIES:

A light to dark green liquid weighing about 14 lbs. per gallon. Darkens on exposure to air and light.

PHYSICAL DATA:

Chemical symbol $FeBr_2$ plus H_2O. Specific gravity 1.7. Contains 50% Ferrous Bromide by weight.

USES:

As a liquid catalyst in organic reactions.

PACKING:

30-gallon drums: 425 lbs.
5-gallon jars: 75 lbs.

SHIPPING REGULATIONS: None.

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Annual Report

of

MICHIGAN CHEMICAL CORPORATION

SAINT LOUIS, MICHIGAN

For the Year Ended
December 31, 1945

Officers and Directors

OFFICERS

T. C. DAVIS	*President*
JOHN L. GILES	*Vice-President & General Manager*
ROBERT L. WILSON	*Secretary*
C. FRED MATGEN	*Treasurer*
RUSSELL J. KNAPP	*Assistant Treasurer*

DIRECTORS

T. C. DAVIS
JOHN L. GILES
ROBERT L. WILSON
C. N. JOHNS
GENE TUNNEY

TRANSFER AGENT

National Bank of Detroit
Detroit, Michigan

Saint Louis, Michigan
February 21, 1946

To the Stockholders
MICHIGAN CHEMICAL CORPORATION

There is submitted herewith the annual report of the Michigan Chemical Corporation. Included with the balance sheet and profit and loss summary for the year ending December 31, 1945, is a statement of surplus, all as approved by our auditors, Ernst & Ernst.

During 1945, our sales increased 54% over 1944. There is every indication that sales for 1946 will show an even greater growth.

Earnings for the year after all charges amounted to $175,641, equal to 82c per share on the 213,581.5 shares outstanding at the year end. Depreciation and amortization for the year 1945, totaled $275,000 of which $188,000 represented amortization of emergency facilities. In addition, the remaining unamortized cost of these facilities, amounting to $200,000, was charged off to earned surplus. The amount of depreciation charged to expense during the year represented an increase of 40% over 1944.

It would have been permissible to restate the emergency facilities written off to the extent of about $380,000. Although such action would have had a beneficial effect on earned surplus, your Board, after carefully considering the matter, decided not to restore the facilities to the accounts.

Other facilities, both buildings and equipment, were expanded during the year and further aggressive expansion is under way. Our 1946 program calls for increasing production in every department which means that new and better equipment will be installed and our building program continued. A new fireproof manufacturing building was recently completed and placed in operation. Also we are just completing a new research and pilot plant building in order to provide adequately for our growing research department. All of these facilities have been financed out of working capital and it is believed that we will be able to provide for further plant expansion this year without resort to permanent financing.

The mortgage and bank loans were reduced during the year by $131,000. The mortgage payments of $10,000 per month continue and it is our intention to fully retire this loan during 1946.

All of the 4,039 shares under option at $15 per share were purchased, as well as 5,400 shares under option to employees at $5 per share and 4,369 shares under the provisions of the outstanding warrants. These transactions caused an increase in the outstanding common shares of 13,808 during the year for which the company received $109,430. There were 3,950 options allocated to 49 key employees for 1945, leaving 2,475 of the 10,000 shares authorized by stockholders for sale to employees on or before March 21, 1947. The allocation of these options to employees as an incentive also assures their participation in the growth of the Corporation.

Our DDT production was increased sharply last year and additional facilities are now being installed for the manufacture of this product. Your company is one of the larger producers of this important insecticide. Our PESTMASTER DDT products for farm, factory and home will be distributed throughout the United States this year. Furthermore, our Export Department is finding a ready market abroad for our DDT and other products.

As you will note, the annual report this year includes a catalogue of our products. Where possible, we are sure that you will be interested in promoting the sales of your company's lines. Well-trained technical personnel, along with modern manufacturing and control methods insure the continued production of quality items.

We regret to inform you that William T. Morris, President of Michigan Chemical Corporation since June 24, 1941, died at Memorial Hospital in New York City, on February 6, 1946. Although Mr. Morris had been ill for some time, he continued to exercise an active interest in the corporation up to the time of his death. The encouragement he consistently offered during our struggles to build the Corporation's business plus his patience and leadership will continue as an inspiration to all of us charged with the future of the Michigan Chemical Corporation.

The problems of a growing company are legion. However, we look to the future with confidence and are proud of the progress already made. We hope you visit us, inspect your operating facilities and meet the fine group of men and women employees who have resolved to make Michigan Chemical Corporation a factor in the chemical field.

By order of the Board of Directors
T. C. Davis, President

MICHIGAN CHEMICAL CORPORATION

Balance Sheet, December 31, 1945

ASSETS

CURRENT ASSETS			
Cash:			
On deposit and on hand		$109,290.46	
Cash collateral account—Note A		59,767.28	$ 169,057.74
Deposit with Reconstruction Finance Corporation for payment of local property taxes			5,376.51
Trade accounts receivable—Note A		$334,847.31	
Less reserve		10,000.00	324,847.31
Refundable federal taxes on income of year 1941 and accrued interest			8,957.95
Inventories—at lower of cost (first-in, first-out method) or market:			
Finished products	$152,201.97		
Work in process	8,219.17		
Raw materials	144,988.12	$305,409.26	
Fuel and supplies		40,344.35	345,753.61
TOTAL CURRENT ASSETS			$ 853,993.12
INVESTMENTS AND OTHER ASSETS			
Cash surrender value of life insurance—Note B		$ 6,700.00	
Equity in foreign enterprise		4,322.95	
Capital stock of Michigan Salt Company (100% owned)—at cost		1,000.00	
Deposits, advances, and miscellaneous accounts		2,927.68	14,950.63
PROPERTY, PLANT, AND EQUIPMENT—at cost, less reserves for depreciation—Note B			
Land		$ 14,345.45	
Wells and reservoir	$126,290.39		
Buildings and other structures	159,518.36		
Machinery and equipment	585,411.69		
	$871,220.44		
Less reserves for depreciation	379,189.60	492,030.84	
Construction in progress (estimated cost to complete—$25,000.00)		120,530.99	626,907.28
DEFERRED CHARGES			
Unexpired insurance premiums			20,225.17
			$ 1,516,076.20

MICHIGAN CHEMICAL CORPORATION

Balance Sheet, December 31, 1945 59

LIABILITIES

CURRENT LIABILITIES		
Notes payable to bank—Note A		$ 100,000.00
Accounts payable:		
Trade accounts	$189,603.32	
Salaries, wages, and commissions	38,718.04	
Pay roll taxes and income taxes withheld from employees	32,151.90	
Miscellaneous	11,668.00	272,141.26
Accrued taxes and interest		6,362.09
Payments due on mortgage loan prior to January 1, 1947		112,171.53
TOTAL CURRENT LIABILITIES		$ 490,674.88
MORTGAGE LOAN—Note B		
From Reconstruction Finance Corporation, payable in monthly installments of $10,000.00 including interest at 4%	$246,521.08	
Less installments on principal due prior to January 1, 1947, included in current liabilities	112,171.53	134,349.55
CAPITAL STOCK AND SURPLUS—Notes B and C		
Common stock, par value $1.00 per share:		
Authorized 250,000 shares		
Unissued (of which 13,981 shares are reserved) 36,418½ shares		
Issued and outstanding 213,581½ shares	$213,581.50	
Capital surplus	662,603.95	
Earned surplus	14,866.32	891,051.77
		$ 1,516,076.20

See notes to financial statements.

MICHIGAN CHEMICAL CORPORATION

Year Ended December 31, 1945

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PROFIT AND LOSS SUMMARY

Sales, less cost of products sold		$435,674.80
Expenses:		
Selling and advertising	$145,985.52	
Administrative and general	101,634.20	247,619.72
		$188,055.08
Other income		3,011.92
		$191,067.00
Interest expense		15,425.52
		$175,641.48
Federal taxes on income—estimated:		
Normal tax, surtax, and excess profits tax on income of the year in the amount of $110,000.00 are eliminated by credit resulting from carry-over of net operating losses of preceeding two years, which losses arose principally from adjustments of amortization of emergency facilties charged to earned surplus in 1945		-0-
NET PROFIT		$175,641.48

Provision for depreciation of property, plant, and equipment for the year charged to costs and expenses, amounted to $274,755.01, including $188,168.63 for amortization of emergency facilities.

See notes to financial statements.

STATEMENT OF SURPLUS

Capital surplus:	
Balance at January 1, 1945	$566,981.95
Excess of selling price over par value of 13,808 shares of common stock issued during the year	95,622.00
Balance at December 31, 1945	$662,603.95
Earned surplus:	
Balance at January 1, 1945	$ 39,920.49
Net profit for the year	175,641.48
	$215,561.97
Less additional amortization of emergency facilites applicable to prior years—Note E	200,695.65
Balance at December 31, 1945	$ 14,866.32

See notes to financial statements.

MICHIGAN CHEMICAL CORPORATION

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NOTES TO FINANCIAL STATEMENTS

Note A—Notes payable represent bank loans which are secured by a general assignment of trade accounts receivable. Under terms of the loan agreement, collections on assigned accounts are deposited with the bank in a collateral account and are available to the Corporation on demand to the extent that such deposits, together with 80% of the accounts receivable, exceed the loans.

Note B—The mortgage loan is secured by a mortgage on property, plant, and equipment of the Corporation, except delivery equipment and office furniture and fixtures, and by an assignment of a life insurance policy. Under the terms of the mortgage loan agreement, the Corporation has agreed, among other covenants, that it will not, without prior consent of Reconstruction Finance Corporation, pay dividends or make any distribution upon its capital stock, or purchase or retire any of its capital stock. In addition to fixed monthly payments of $10,000.00 each including interest, the Corporation is required to make additional payments on principal on March 1st of each year in the amount by which fifty per cent of net earnings before depreciation for the preceding year exceeds the aggregate monthly amounts paid on principal in such year. Reconstruction Finance Corporation has waived this requirement as to the additional payment due March 1, 1946, which payment would have amounted to $117,412.86.

Note C—At December 31, 1945, 13,981 shares of unissued common stock were reserved, as follows:

For issuance upon sale to management and key employees of the Corporation at $5.00 per share on or before March 21, 1947	9,600	shares
For exercise of outstanding purchase warrants at $5.00 per share on or before March 1, 1947	4,381	
TOTAL	13,981	shares

During the year, rights to purchase capital stock were exercised as follows:

Management and key employees at $5.00 per share	5,400	shares
Purchase warrants expiring March 1, 1947, at $5.00 per share	4,369	
Purchase warrants expiring June 30, 1945 (extended to November 30, 1945), at $1 00 per share	4,039	
TOTAL	13,808	shares

On January 2, 1945, the Corporation allotted to certain employees rights to purchase 3,825 shares of its unissued common stock at a price of $5.00 per share, and 400 shares thereof were purchased during the year. Such allotment represented a part of the 15,000 shares reserved (of which 5,000 shares were concurrently allotted) on March 21, 1944, for sale on or before March 21, 1947, to management and key employees at $5.00 per share, which was the approximate market

ceding year exceeds the aggregate monthly amounts paid on principal in such year. Reconstruction Finance Corporation has waived this requirement as to the additional payment due March 1, 1946, which payment would have amounted to $117,412.86.

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Note D—Proceedings under the Renegotiation Act for the year ended December 31, 1944, have been completed and no refund of profits was required. Renegotiation data for the year ended December 31, 1945, has not yet been filed and no determination of the amount, if any, which may be refundable is possible at this time; however, the profits on war contracts for the year are considered to be reasonable and no provision for refund is believed to be required.

Note E—The Corporation has elected to terminate amortization of its emergency facilities as of September 30, 1945, and has fully amortized the facilities as of that date. Additional amortization applicable to prior years in the amount of $200,695.65 has been charged to earned surplus. The effect of such additional amortization on profit and loss previously reported for prior years is as follows:

YEAR	PROFIT-LOSS* PREVIOUSLY REPORTED	ADDITIONAL AMORTIZATION	ADJUSTED LOSS FOR YEAR
1942	$ 31,089.78*	$ 7,076.85	$ 38,166.63
1943	101,348.35*	82,663.26	184,011.61
1944	82,421.42	110,955.54	28,534.12

BOARD OF DIRECTORS,
MICHIGAN CHEMICAL CORPORATION,
SAINT LOUIS, MICHIGAN.

We have examined the balance sheet of Michigan Chemical Corporation as of December 31, 1945, and the statements of profit and loss and surplus for the year then ended, have reviewed the system of internal control and the accounting procedures of the Corporation and, without making a detailed audit of the transactions, have examined or tested accounting records of the Corporation and other supporting evidence, by methods and to the extent we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary. It was not practicable to confirm by direct communication the accounts receivable from United States Government departments, but we satisfied ourselves as to such accounts by means of other auditing procedures.

In our opinion, the accompanying balance sheet and related summary of profit and loss and statement of surplus present fairly the position of Michigan Chemical Corporation at December 31, 1945, and the results of its operations for the year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

ERNST & ERNST

Certified Public Accountants

Grand Rapids, Michigan
February 15, 1946

HYDROBROMIC ACID (48%)

GENERAL PROPERTIES:

Hydrobromic Acid is a solution of hydrogen bromide gas in water, a liquid of clear or slightly yellowish color. Specific gravity 1.49. Boiling point 126°. Hydrogen bromide is a colorless, pungent, very irritating gas, fumes in moist air.

PHYSICAL DATA OF HYDROGEN BROMIDE GAS:

Chemical symbol HBr. Molecular weight 80.93. Bromine 98.75%. Specific Gravity 2.71 (Air-1). M.p. –86°C. Boiling point –67°C. One gram of water dissolves 2.21 grams of the gas at 0° and 1.30 g. at 100°. Soluble in alcohol.

USES: Medicinal

Nervous affections, nerve sedative, vertigo, seasickness, epilepsy.

Industrial

Manufacture of bromides, organic synthesis, and analytical chemistry. In the isolation of radium.

GRADES PRODUCED: Purified.

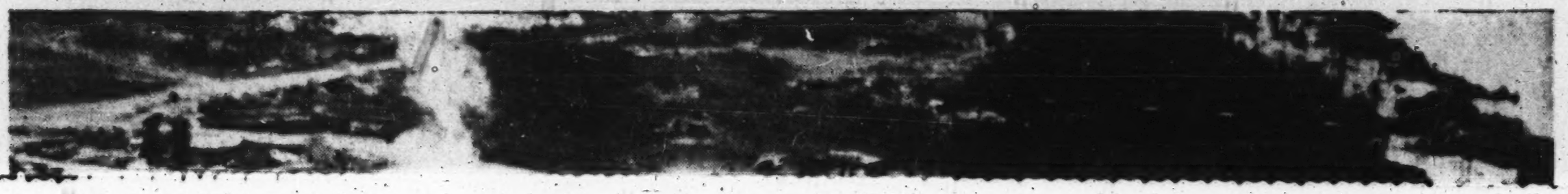
SHIPPING REGULATIONS:

Railroad shipping regulations: White label ICC No. 4.
Steamer regulations: On deck.

PACKING:

5-gal. Carboys (60 lbs.), 13-gal. Carboys (150 lbs.)

Magnesium Oxide products are manufactured in this modern plant.



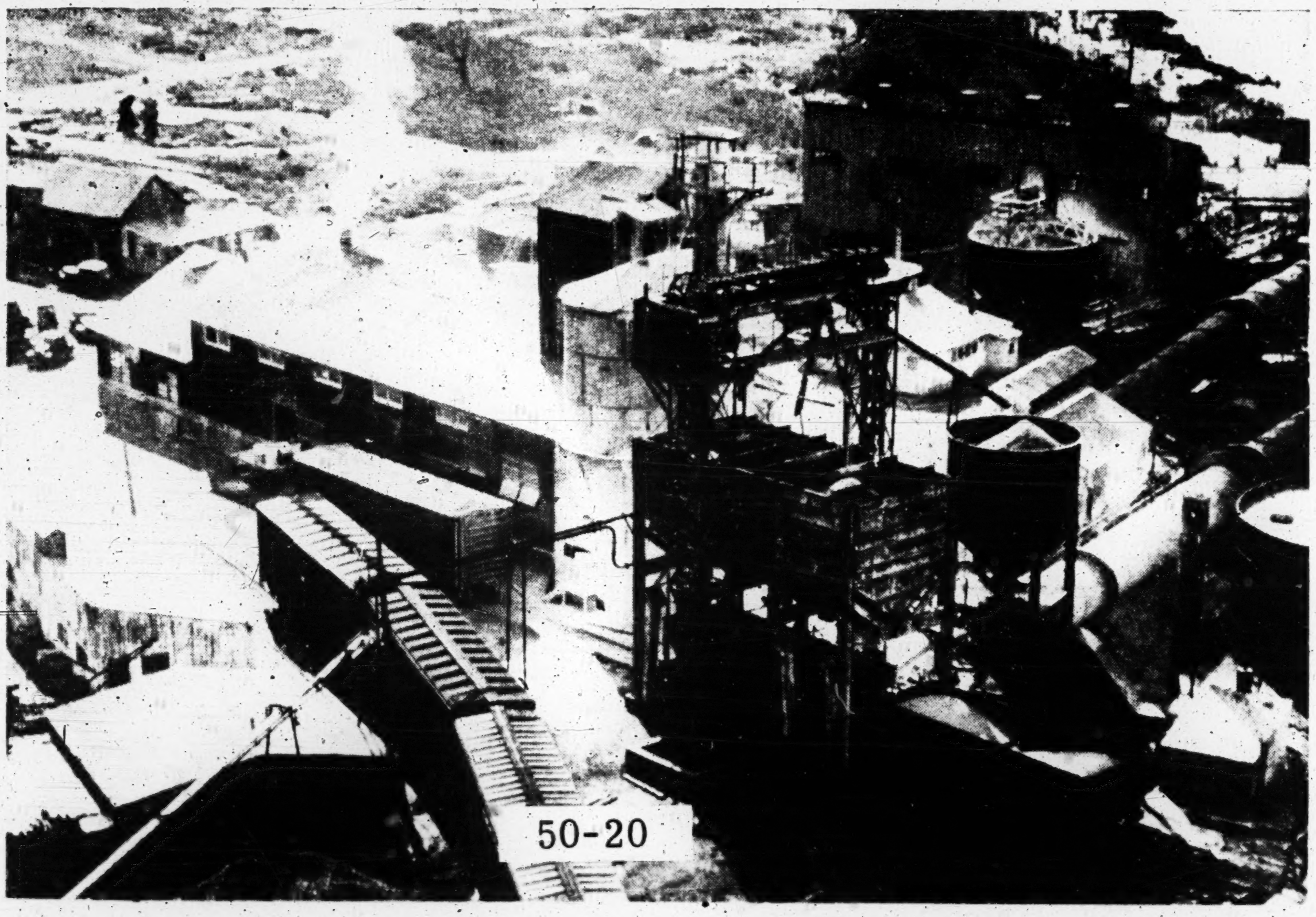
SHIPPING REGULATIONS:

Railroad shipping regulations: White label ICC No. 4.
Steamer regulations: On deck.

PACKING:

5-gal. Carboys (60 lbs.), 13-gal. Carboys (150 lbs.)

Magnesium Oxide products are manufactured in this modern plant.



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MAGNESIUM BROMIDE

GENERAL PROPERTIES:

White or colorless very deliquescent crystals with a bitter, saline taste.

PHYSICAL DATA:

Chemical Symbol $MgBr_2.6H_2O$. Mg. 8.32%; Br. 54.69%; H_2O 36.99%. Molecular weight 292.15. Specific gravity about 2.0; loses water of crystallization at 165°; soluble 0.3 pts. water, alcohol, acetic acid.

USES:

Sedative in nervous insomnia, hysteria, tetanus, epilepsy, etc.

SHIPPING REGULATIONS: None

PACKING:

5-lb. Bottles packed 10 to the Wooden Case, 30-lb. Bottles.

MAGNESIUM OXIDE PRODUCTS

Increasing consumer demand for the various grades of Michigan Chemical Corporation's Magnesia further establishes the superior quality of this synthetic material using as its basic raw material source Central Michigan's pure natural brine deposits.

The suitability of Magnesia for various uses is dependent upon such physical properties as particle size, absorptiveness, apparent specific gravity, physical and chemical reactivity, thermal and dielectric characteristics. Over a period

PACKING:

5-lb. Bottles packed 10 to the Wooden Case, 30-lb. Bottles.

MAGNESIUM OXIDE PRODUCTS

Increasing consumer demand for the various grades of Michigan Chemical Corporation's Magnesia further establishes the superior quality of this synthetic material using as its basic raw material source Central Michigan's pure natural brine deposits.

The suitability of Magnesia for various uses is dependent upon such physical properties as particle size, absorptiveness, apparent specific gravity, physical and chemical reactivity, thermal and dielectric characteristics. Over a period of years our laboratories have made a thorough study of this interesting chemical, together with exhaustive tests on the semi-manufacturing scale. Our wide experience in the calcining and processing of Magnesia place us in a position to manufacture it for practically any desired use or specification.

A variety of grades, ranging in bulk density from light to dense and with chemical specifications indicating low limits on lime, silica, iron, alumina, and manganese.

Properties and specifications on a partial list of grades presently available are offered on the following pages.

Equipment is now being installed to manufacture additional grades to meet the requirements of our many present and anticipated customers.

MICHIGAN NO. 1 CALCINED MAGNESITE

PROPERTIES:

Grayish white powder or granules.

TYPICAL ANALYSIS:

Ignition loss	0.2	
SiO_2	.4	ignited basis
Fe_2O_3	.2	
Al_2O_3	.2	
CaO	1.6	
MgO (by diff.)	97.6	

BULK DENSITY:

65 pounds per cubic foot.

SCREEN ANALYSIS:

Granules 1/20" to ½" as ordered.
Powder any mesh down to 99% through 325 mesh.

USES:

For high temperature refractories, metallic magnesium, etc.

PACKING:

100-pound 5 ply multiwall paper bag, one layer asphalt.

Brine from the Corporation's wells is stored and treated in these tanks.



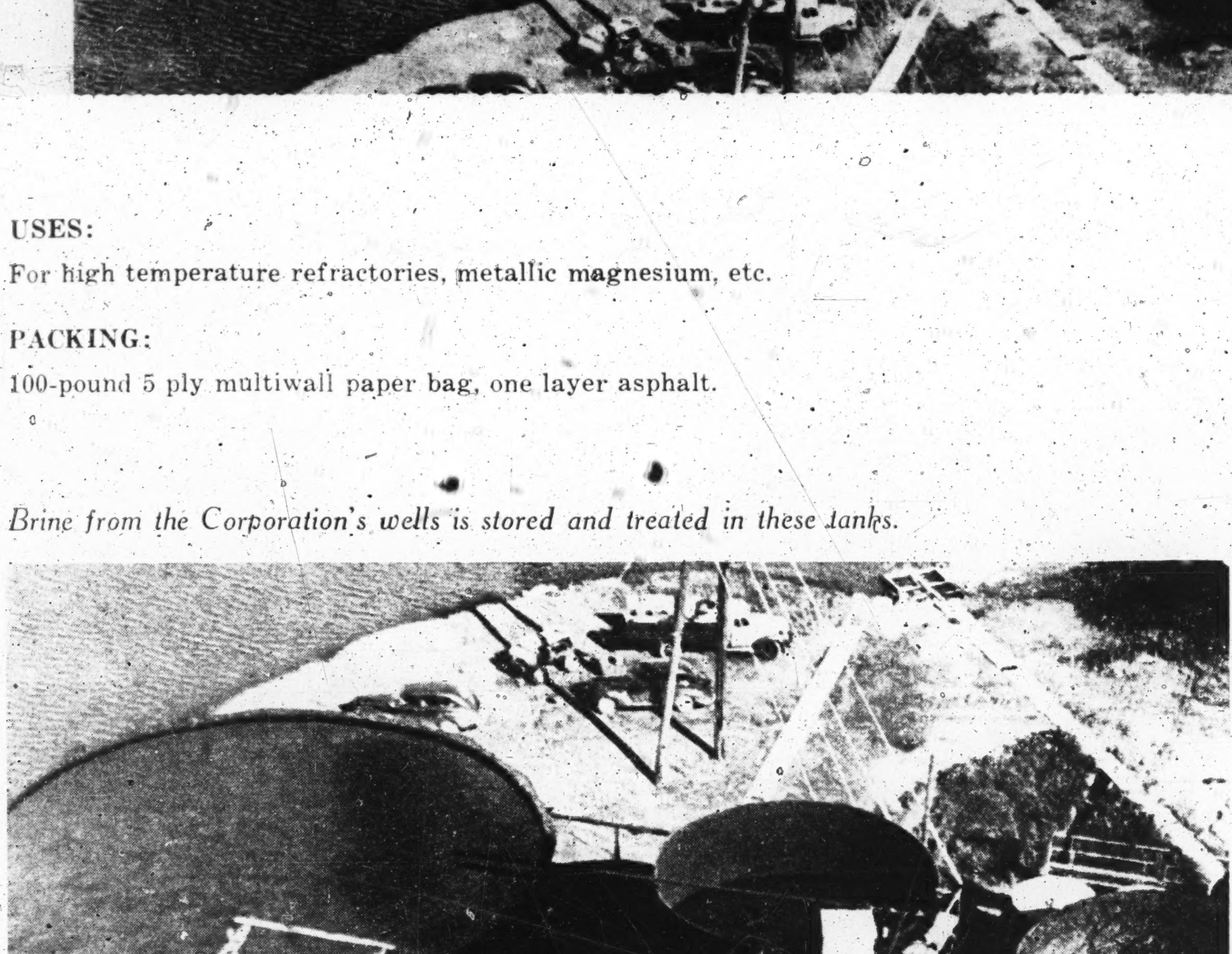
USES:

For high temperature refractories, metallic magnesium, etc.

PACKING:

100-pound 5 ply multiwall paper bag, one layer asphalt.

Brine from the Corporation's wells is stored and treated in these tanks.

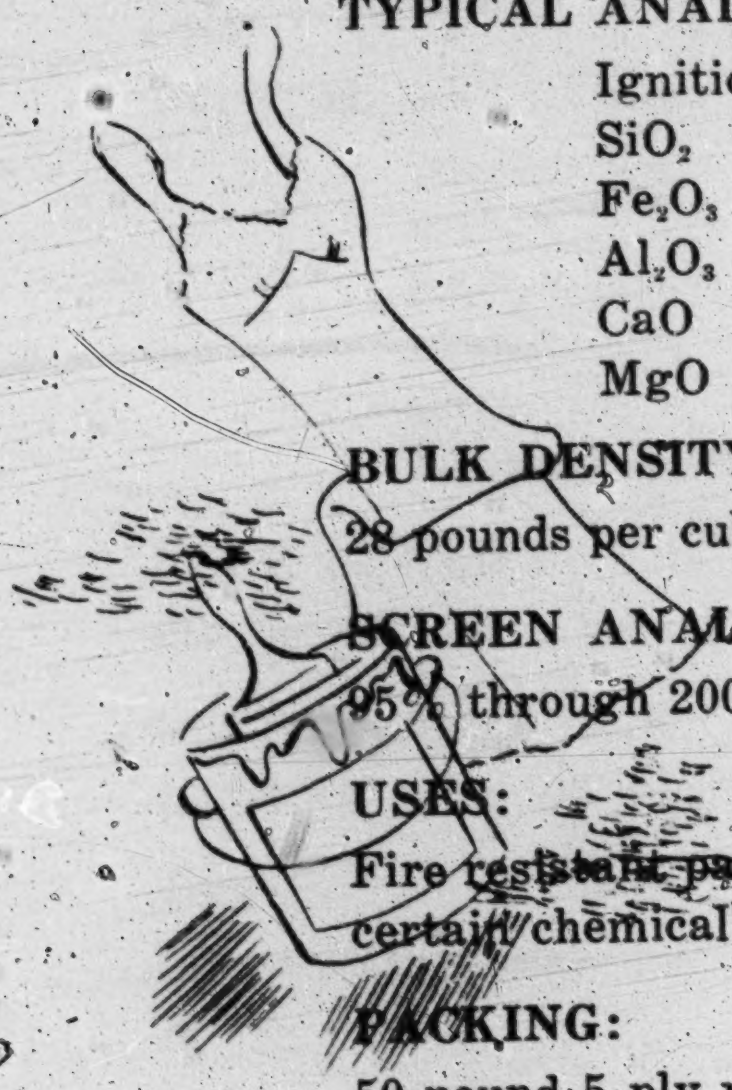


MICHIGAN NO. 5 CALCINED MAGNESITE

PROPERTIES:

White powder or soft lumps if unground.

TYPICAL ANALYSIS:



Ignition loss	1.5	
SiO_2	.4	ignited basis
Fe_2O_3	.2	
Al_2O_3	.2	
CaO	1.6	
MgO (by diff.)	97.6	

BULK DENSITY:

28 pounds per cubic foot.

SCREEN ANALYSIS:

95% through 200 mesh.

USES:

Fire resistant paints, dyes, rayon, chrome glues, thermal shock resistant glass, certain chemical uses, flux for metallic magnesium.

PACKING:

50-pound 5 ply multiwall paper bag, one layer asphalt.

MICHIGAN NO. 15 HEAVY CALCINED MAGNESIA TECHNICAL

PROPERTIES:

Fine white powder.

TYPICAL ANALYSIS:

Ignition loss	1.5
SiO_2	?

certain chemical uses, flux for metallic magnesium.

PACKING:

50-pound 5 ply multiwall paper bag, one layer asphalt.

MICHIGAN NO. 15 HEAVY CALCINED MAGNESIA TECHNICAL

PROPERTIES:

Fine white powder.

TYPICAL ANALYSIS:

Ignition loss	1.5	
SiO_2	.2	ignited basis
Fe_2O_3	.2	
Al_2O_3	.2	
CaO	1.5	
MgO (by diff.)	97.7	

BULK DENSITY:

25 pounds per cubic foot.

SCREEN ANALYSIS:

99.5% through 325 mesh.

USES:

Rubber compounding.

PACKING:

40-pound 5 ply multiwall paper bag, one layer asphalt.

MICHIGAN NO. 30 LIGHT CALCINED MAGNESIA TECHNICAL

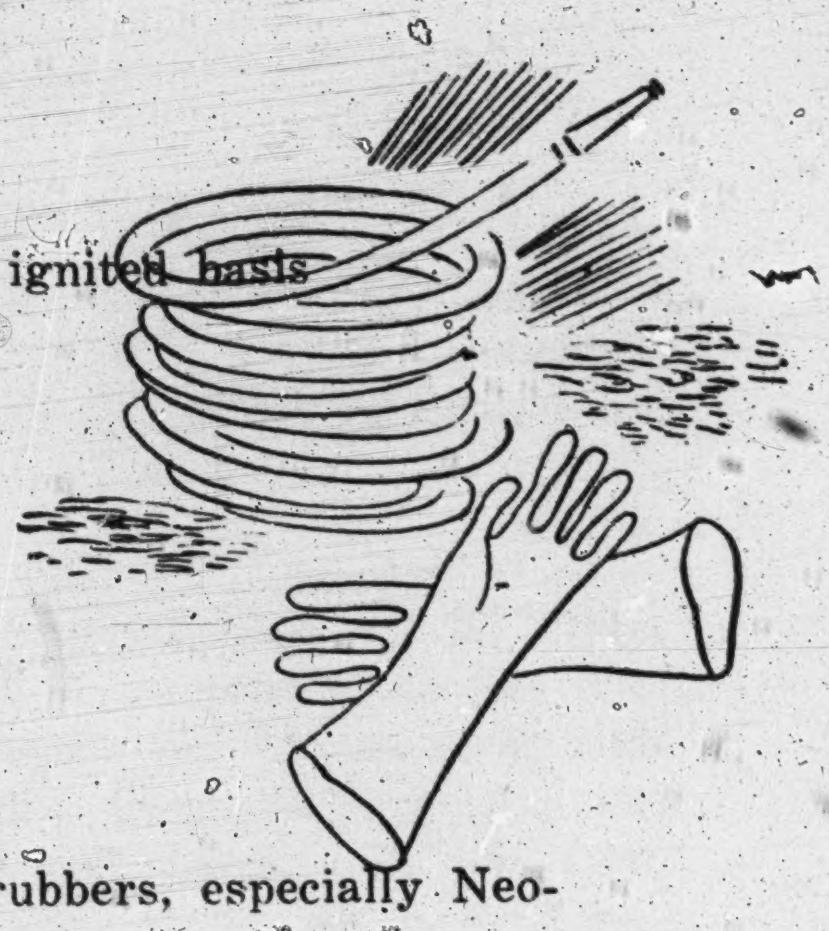
PROPERTIES:

Light weight, fine white powder.

TYPICAL ANALYSIS:

Ignition loss	1.5
SiO_2	.4
Fe_2O_3	.2
Al_2O_3	.2
CaO	1.5
MgO (by diff.)	97.7

ignited basis



BULK DENSITY:

8½ pounds per cubic foot.

SCREEN ANALYSIS:

99.5% through 325 mesh.

USES:

Compounding ingredient for natural and synthetic rubbers, especially Neoprene.

PACKING:

25-lb. 5 ply multiwall paper bag with one layer asphalt.

MICHIGAN MAGNESIUM HYDROXIDE

PROPERTIES:

Light weight fine, white powder.
Light weight ⅛" granules.

TYPICAL ANALYSIS:

prene

PACKING:

25-lb. 5 ply multiwall paper bag with one layer asphalt.

MICHIGAN MAGNESIUM HYDROXIDE

PROPERTIES:

Light weight fine, white powder.
Light weight ⅛" granules.

TYPICAL ANALYSIS:

Free moisture	1.50%
SiO_2	.20
Fe_2O_3	.12
Al_2O_3	.12
CaO	1.20
$Mg(OH)_2$ by diff.	96.86

BULK DENSITY:

20 pounds per cubic foot.

SCREEN ANALYSIS:

For powder form, 99% through 325 mesh.

USES:

Manufacture of magnesium oxide, other magnesium compounds.

PACKING:

40-pound 5 ply multiwall paper bag, one layer asphalt.

METHYL BROMIDE

GENERAL PROPERTIES:

Methyl Bromide is a colorless gas at ordinary temperature. When liquified it is a volatile colorless liquid with burning taste and chloroform-like odor. It is non-inflammable and the gas is POISONOUS.

PHYSICAL DATA:

Chemical Symbol CH_3Br. Bromine 84.18%. Molecular wt. 94.94. Specific gravity 1.732 0°/4°C; b.p. 4.6°C. Miscible with most organic solvents; forms a voluminous crystalline hydrate with cold water. Freely soluble in alcohol, chloroform, ether, carbon disulfide. Must be kept in tightly sealed containers.

USES: Commercial and Industrial.

Methyl Bromide is rapidly becoming the outstanding fumigant for all grain, fresh fruit and vegetables, plants. etc. Also used in organic synthesis; low-boiling solvent and refrigerating. Methyl Bromide is a non-inflammable, non-corrosive fumigant for grain, flour, fresh fruit, vegetables, plants, and for the extermination trade. In tight bins, cars and rooms, 1 lb. per 1,000 square feet is deadly to all insect life. If room is not tight, use 2 or 3 lbs. per 1,000 square feet. Other uses are as organic synthesis, methylating agent, solvent, refrigerant, ingredient of fire extinguisher fluid.

GRADE PRODUCED: Technical.

SHIPPING REGULATIONS: Class B. Poison.

Poison labed required. See ICC 4.

PACKING:

1-lb. Tin Cans packed 24 to wooden case, 10-lb. Steel Cylinders, 50-lb. Steel Cylinders, 150-lb. Steel Cylinders, 400-lb. Steel Cylinders.

PHOSPHOROUS TRIBROMIDE

GENERAL PROPERTIES:

Colorless or slightly yellowish clear liquid, with a penetrating odor. Fumes on exposure to air. Reacts violently, explosively, with water.

PHYSICAL DATA:

Chemical Symbol PBr_3, Bromine 88.54%. Molecular wt. 270.77; Specific gravity 2.88 at 25°C; m.p. –40°; boiling point 169°-171° at 740 mm; decomposes water and alcohol; soluble ether, chloroform, carbon tetrachloride. Must be kept in tightly closed glass containers.

USES:

Laboratory reagent for preparation of organic compounds, as a catalyst.

GRADES: Purified.

SHIPPING REGULATIONS:

White Label. 1-qt. Express limit. Wooden Boxes with Glass or Earthenware inside containers. Not over 1 gal. each. Sec. ICC 4.

PACKING:

20-lb. Bottles packed 5 to wooden case.

POTASSIUM BROMIDE

GENERAL PROPERTIES:

White, odorless granules, powder or pellets, bitter saline taste; somewhat hygroscopic. When exposed to air absorbs moisture and tends to harden. Keep containers well closed.

In the exclusive Michigan Chemical "Pellet" form the tendency to harden is very greatly reduced.

PHYSICAL DATA:

Chemical Symbol KBr. K 32.85%, Br. 67.15%. 99-99.5% pure. Molecular wt. 119.01. Specific gravity 2.749. M.p. 730°C. B.p. 1435°C. One gram dissolves in 1.5 cc water, 1 cc boiling water, 250 cc alcohol, 21 cc boiling alcohol, 4.6 cc glycerin. The aqueous solution is neutral.



USES: Medicinal

To check convulsions, antiepeleptic, sedative, nervous disorders, seasickness, whooping cough and many more complicated conditions.

Industrial

Manufacture of photographic papers and plates, process engraving and lithography, gelatin bromide papers and plates.

GRADE PRODUCED: U.S.P. XII

Furnished in 20-40 Mesh Granular; 8-16 and 16-20 Mesh Pellets. May be obtained by special order in 4-8 Mesh Pellets.

SHIPPING REGULATIONS: None.

PACKING:

25-lb. Drums, 100-lb. Drums, 400-lb. Barrels.

SODIUM BROMIDE

GENERAL PROPERTIES:

White, odorless granules, powder or pellets, saline, slightly bitter taste. Absorbs moisture from the air without diliquescing. Granular material tends to harden. Keep containers well closed.

In the exclusive Michigan Chemical "Pellet" form this tendency to harden is greatly reduced.

PHYSICAL DATA:

Chemical Symbol NaBr. Na 22.35%, Br. 77.65%. 99-99.5% Pure. Molecular wt. 102.9. Specific Gravity 3.21. Melts 755°C; volatilizes at slightly higher temperature. One gram dissolves in 1.1 cc water, about 16 cc alcohol, 6 cc. methanol. Incompatible with acids, alkaliodal and heavy metal salts. The aqueous solution is practically neutral. Below 51°C Soduim Bromide crystallizes with $2H_2O$ in the form of colorless crystals.

USES: Medical

For use as nerve sedative and cerebral depressant.

Industrial

Manufacture of photographic emulsions—used as a constituent of Mining Salts, manufacture of organic chemicals, other bromides and as a source of bromine.

GRADE PRODUCED: U.S.P. XII

Furnished in 20-40 Mesh Granular and 16-20 Mesh Pellets and 8-16 Mesh.

SHIPPING REGULATIONS: None.

PACKING:

25-lb. Drums, 100-lb. Drums, 500-lb. Barrels.

SODIUM CHLORIDE

Salt; Common Salt. Commercial article is also known as table salt, rock salt, or sea salt. The U.S.P. grade is 99.5% pure. The "salt" in general use is 98-99% pure.

GENERAL PROPERTIES:

White crystals, granular or powder, somewhat hygroscopic. Pure Sodium Chloride is not hygroscopic. Most salt contains some calcium or magnesium chlorides which absorb moisture and make it cake.

PHYSICAL DATA:

Chemical Symbol, NaCl. Molecular wt. 58.45; Na. 39.34%, Cl 60.66%. Specific

gravity 2.161; m.p. 804°C; b.p. 1.490°C; Soluble in water and glycerin; very slightly soluble in alcohol.

USES: Medicinal

Intravenous, hemorrhage, acidosis, poisoning, and for loss of body fluids. In sprays in chronic catarrh of larynx and harynx; also as neutralizing wash after using silver nitrate.

Industrial

Source of chlorine and of sodium as well as practically all of their compounds. e. g., hydrochloric acid, chlorates, sodium carbonate, etc. Freezing mixtures, dying and printing fabrics, glazing pottery and ceramic, curing hides, metallurgy of tin and other metals, glass, food preservatives, mineral waters. fertilizers, analytical chemistry and paper.

GRADES PRODUCED:

U.S.P. XII for medicinal and similar uses and Technical and Coarse grades for other purposes.

No railroad or steamship regulations.

PACKING:

100-lb Drums, 280-lb. Barrels.

STRONTIUM BROMIDE

PACKING:

100-lb Drums, 280-lb. Barrels.

STRONTIUM BROMIDE

GENERAL PROPERTIES:

White, hygroscopic powder or small crystals. Must be kept well stoppered.

PHYSICAL DATA:

Chemical Symbol $SrBr_2 6H_2O$. Molecular wt. 355.56. Specific gravity 4.216. Loses water of crystalization at 180°C. Melting point of anhydrous $SrBr_2$, 630°. Decomposes at boiling point. Soluble in water, alcohol and amyl alcohol.

USES: Medicinal

Similar to the uses of Potassium Bromide.

GRADE PRODUCED: N. F. VII

SHIPPING REGULATIONS: None.

PACKING:

25-lb. Drums, 50-lb. Glass Jars, 100-lb. Drums, 300-lb. Barrels.

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ZINC BROMIDE

GENERAL PROPERTIES:

A concentrated solution of Zinc Bromide, containing 80-82%. Will deposit crystals of hydrated $ZnBr_2$ when exposed to very cold temperatures.

PHYSICAL DATA:

Chemical Symbol $ZnBr_2$ and H_2O. Molecular weight 225.2; Specific gravity of liquor about 2.62; boiling above 150°C. Weight per gallon about 22 pounds.

USES:

As a liquid catalyst medium in organic reactions.

GRADE PRODUCED: Technical.

SHIPPING REGULATIONS: None.

PACKING:

5-gallon Carboys (110 lbs.), 30-gallon Drums (550 lbs.).

Michigan Chemical Research

Michigan Chemical Corporation started operation in 1936 with four products, bromine, sodium bromide, potassium bromide, and salt being manufactured. Research and development started with the plant operations and this original list now has grown to include over 20 chemicals, some of which are made in several grades.

In 1939 Michigan Chemical introduced a complete list of granular bromides, including the new and unique pellet form, which received instant and enthusiastic acceptance in the trade.

Full time research was instituted at the beginning of 1940 and during the ensuing two years a complete line of the more important bromides was developed.

In response to an urgent war demand, a magnesia plant was constructed in 1942, while laboratory and pilot plant research was rushed concurrently. Magnesia for refractories and other uses was soon being shipped out in car-

load lots. There arose in the latter part of 1943 a critical need for light magnesia for the compounding of Neoprene and other synthetic rubbers. The Government's rubber-production program was endangered, but Michigan Chemical stepped into the gap and, with a process which is a credit to our engineers, supplied the needed tonnages of special light magnesia.

Development of the new insecticide, DDT, began in April, 1944. The tremendous size of this development, together with the urgent need by the Army, Navy and Red Cross, necessitated a great expansion of our research staff. Within six months, DDT was being rushed to the war fronts and Michigan Chemical is now one of the largest manufacturers of this item. Our Corporation was commended for this outstanding war achievement by the Surgeon General of the United States Army.

Today, Michigan Chemical research and product development are going forward on an ever-increasing scale under the direction of competent and experienced chemists and engineers. A two-story 40 foot by 100 foot building, just completed, gives us complete facilities.

On January 1, 1946 a Technical Service Department was instituted to provide better service to our customers and work out possible new uses for our products.

Constant development is and will be our policy.

Fine Chemicals Department



Our Fine Chemicals Department is fully staffed and well equipped. It is prepared to undertake the production of a large variety of special chemicals, in amounts ranging from a few pounds to several hundred; particularly organic chemicals and rare and unusual compounds of the halogens.

Michigan Chemical has a vast background of experience in the technology of bromine compounds, both organic and inorganic. Many of the alkyl, aromatic and metal bromides find wide application as intermediates in the synthesis of pharmaceuticals, dyes, perfumes and other organics. The various inorganic bromides are highly useful as catalysts in organic synthesis, both in their water solutions and in solutions of organic solvents.

A number of these chemicals are available in research quantities and our Fine Chemicals Department will be glad to advise you regarding their use and application.



MICHIGAN CHEMICAL CORPORATION

Plant and Main Office, Saint Louis, Michigan

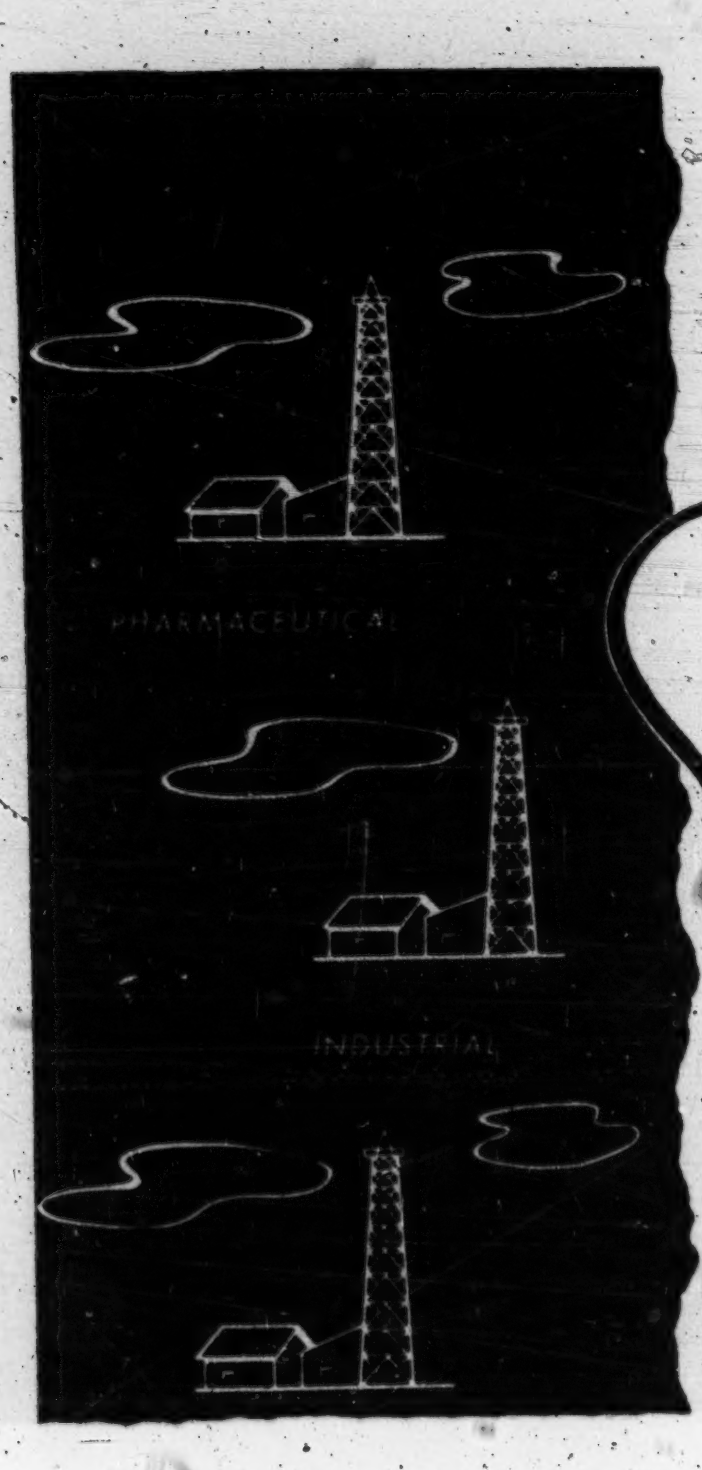
EASTERN SALES OFFICE, 230 PARK AVENUE, NEW YORK 17, NEW YORK

EXPORT DIVISION, SAINT LOUIS, MICHIGAN—CABLE ADDRESS "MICHEMCO"

50-31 PRINTED IN U. S. A.

Exhibit 16

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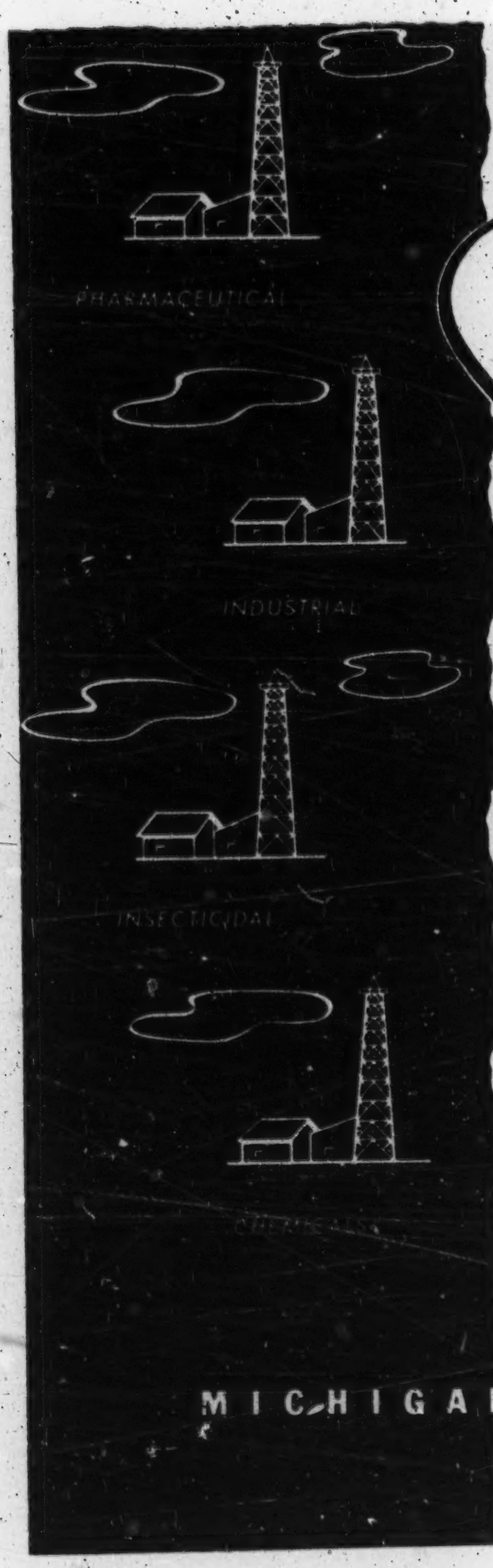


annual report

YEAR ENDED DECEMBER 31, 1946

Michigan Chemical Corporation

THE TAX COURT OF THE U.S.
DIV. 12 DOCKET 4 / 5
ADMITTED IN EVIDENCE
1953

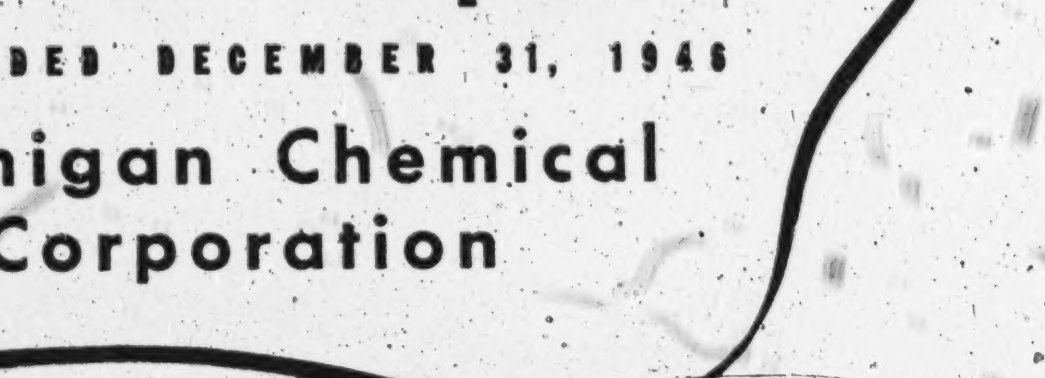


annual report

YEAR ENDED DECEMBER 31, 1946

Michigan Chemical Corporation

THE TAX COURT OF THE U.S.
DIV. 12 DOCKET 4 / 5
ADMITTED IN EVIDENCE
OCT 14 1953
PET.'S EXHIBIT 16
RESPONDENT'S



MICHIGAN CHEMICAL CORPORATION

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Foreword

Michigan Chemical Corporation presents on the following pages information pertaining to its past, present, and future operations. This report contains, in addition to the Financial Statements, illustrations and descriptions of plant facilities, products and their uses, product distribution, research, and interesting comparisons between 1946 and the normal prewar year of 1940.

Using as its basic source of supply a natural brine rich in mineral deposits, Michigan Chemical Corporation manufactures a wide variety of Pharmaceutical, Industrial, and Insecticidal chemicals in its modern plant located at Saint Louis, Michigan. In the brief period of eleven years your Company has established a reputation the world over for manufacturing uniformly high quality products.

During the past year new plant facilities have been added to meet the expanding market for our products. In 1946 your Company successfully established for the first time national distribtion of a consumer line — household DDT insecticides.

Cognizant of the part chemicals will play in the immediate future, Michigan Chemical Corporation is prepared to assume an ever-increasingly important position. Emphasis on research, expanded facilities, and a sound marketing program offer the assurance of meeting this objective.

Michigan Chemical Corporation

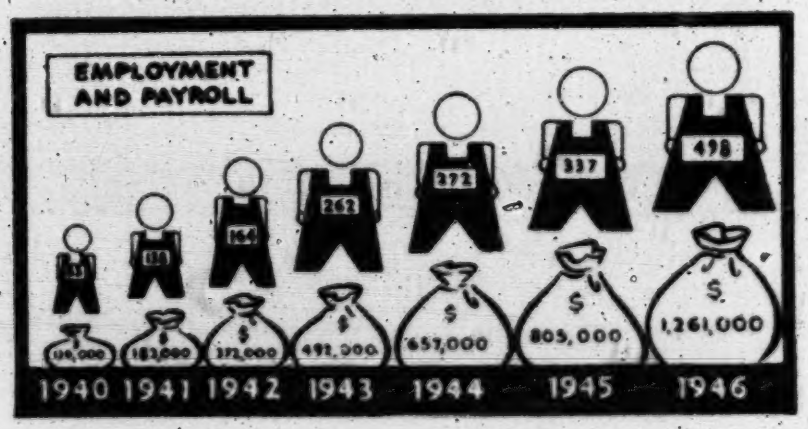
Our Business

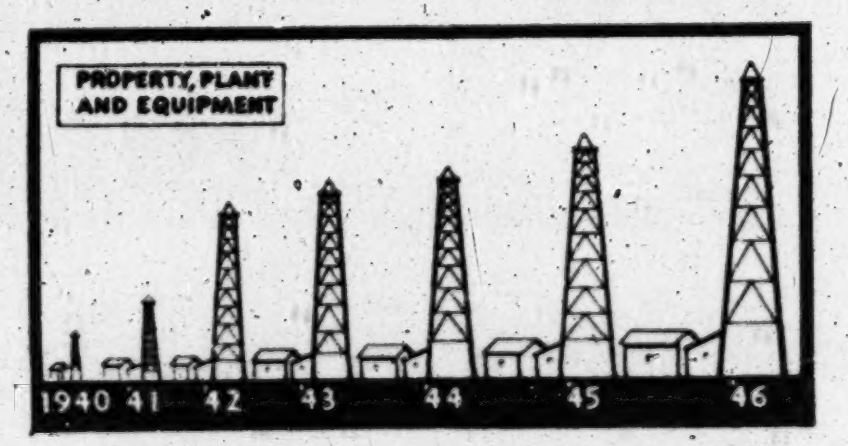
Chartered as a Michigan Corporation on February 21, 1935, Michigan Chemical Corporation after 11 years of operation has established itself as a definite factor in the Chemical Industry.

Utilizing Central Michigan's rich natural brine deposits as its chief source of raw material, Michigan Chemical Corporation specializes in the manufacture of Pharmaceutical, Industrial and Insecticidal Chemicals.

The plant and main office are located at Saint Louis, Michigan. Originally the plant site consisted of 14 acres of land. At present the Company owns additional parcels of 16 acres and 40 acres adjacent to the original property. Sufficient area is now held to provide for future expansion. Adequate water supply is available from the Pine River which bounds the property on the north. Excellent trucking facilities are provided by trunk lines M-46 and US-27. The Pere Marquette Railroad connects with the Company's rail siding.

Products of Michigan Chemical Corporation are distributed nationally and a substantial volume of business finds a ready





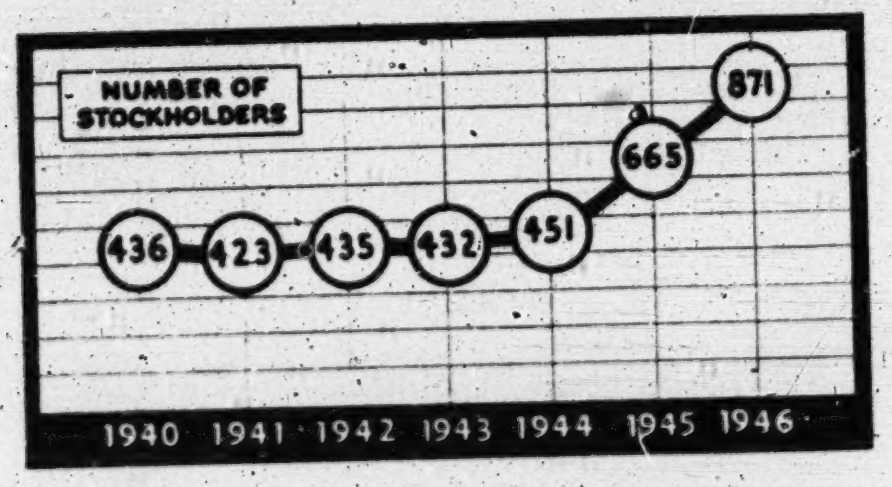
is YOUR Business

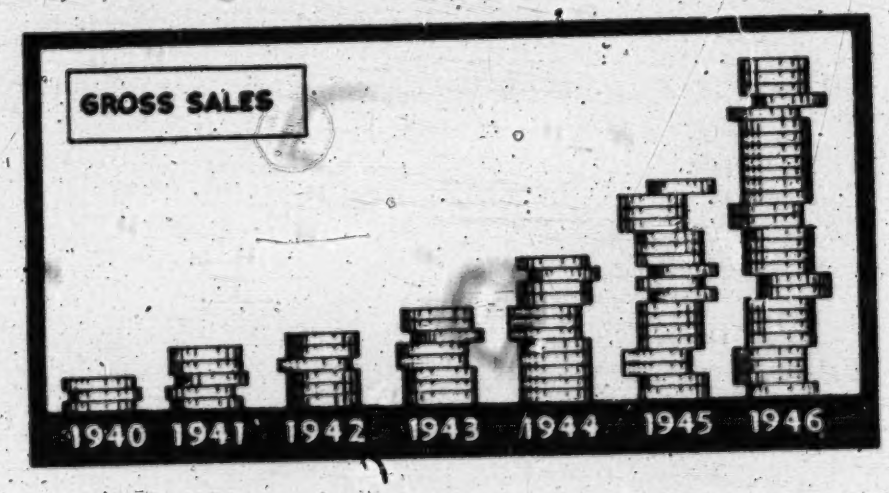
market in foreign countries. A warehouse for the general line is maintained at Jersey City. Household insecticides and fungicides are warehoused at Jersey City, Atlanta, Houston, Los Angeles and San Francisco.

The accompanying charts relating to Employment and Pay Rolls, Property Plant and Equipment, Number of Stockholders, and Gross Sales indicate favorable trends for the period starting with the normal prewar year 1940 through 1946.

The teamwork of Michigan Chemical Corporation employees represents one of the most valuable assets of this enterprise. Safety and health protection are promoted and a Group Insurance Plan offers life, life, sickness and accident, and hospitalization and surgical operating insurance at low rates to all eligible employees. The number of employees increased from 86 in 1940 to 498 in 1946.

The ownership of Michigan Chemical Corporation is widely distributed geographically. In 1946 there were 871 stockholders as compraed to 436 in 1940.





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Chemicals . . .

for today and tomorrow

Michigan Chemical Corporation produces more than thirty essential chemicals which, in turn, are used in the manufacture of a wide variety of products. Among the great basic industries which we serve are rubber, glass, ceramics, coal mining, textile, pharmaceutical, and food processing, to name only a few...

Some of our products are as old as civilization while others are as new as tomorrow's sun. Most of them have a variety of uses. More than 150 tons of evaporated salt, finding over 50 large scale applications, are produced daily in our plant. CRYSTAL FLOW, GOLD MEDAL and RED BAG are recognized quality brands manufactured by Michigan Chemical, and marketed by the Michigan Salt Company, our sales affiliate.



Bromine, of which Michigan Chemical Corporation has always been a large manufacturer, has dozens of uses in its liquid state and in the form of its various compounds.

The interesting group of products which come from our Magnesia plant are used in at least 20 different industries among which are Neoprene rubber compounding, refractories, ceramics and composition flooring.



Michigan Chemical is now one of the largest manufacturers of DDT. This remarkable product, the most versatile of all insecticides, is now distributed nationally under the PESTMASTER trademark for household, agricultural and public health uses. Millions of pounds of DDT concentrates are also being supplied to other manufacturers for use in their formulations.

During the first quarter of 1946 the Corporation placed on the market a selective weed-killer, trade-marked WEEDMASTER, containing the sensational hormone chemical 2,4-Dichlorophenoxyacetic Acid.

New products now under development will supplement our line of insecticides and fungicides so that the Corporation will eventually have a complete line of these products. Other plans call for the fullest development of the possibilities of the brine which furnishes the principal raw material at the Michigan Chemical plant. Purchase of the adjoining Refinery property with its equipment and 15 acres of land will permit the manufacture and exploitation of other products now being developed in our laboratories.



PRODUCTS

- Allyl Bromide
- Aluminum Bromide Anhydrous
- Ammonium Bromide
- n-Amyl Bromide
- Barium Bromide
- Bromine
- Bromoform
- 2-Bromothiophene
- n-Butyl Bromide
- Calcium Bromide
- Calcium-Magnesium Chloride, Liquid
- Chlorobromomethane
- DDT (Dichloro-diphenyl-trichloroethane)
- 2,4-D (2,4-Dichlorophenoxyacetic Acid)
- Ethyl Bromide
- Ferrous Bromide
- Hexaethyl Tetraphosphate
- n-Hexyl Bromide
- Hydrobromic Acid
- Isoamyl Bromide
- Isopropyl Bromide
- Magnesium Bromide
- Magnesia, Extra Light
- Magnesia, Light
- Magnesium Carbonate
- Magnesium Oxide, Heavy
- Methyl Bromide
- Methylene Bromide
- Phosphorus Tribromide
- Potassium Bromide
- Sodium Bromide
- Sodium Chloride
- Strontium Bromide
- Zinc Bromide

USES

- Analytical Reagents
- Anaesthetics
- Antiknock Compounds
- Ballast Liquids
- Ceramics
- Coal Treatment
- Dehydrating Agents
- Dye Intermediates
- Engraving
- Fire Extinguishers
- Fireproofing Compositions
- Fire-Resistant Paints
- Food Products
- Fumigants
- Glue
- Inks
- Insecticides
- Insulation
- Leather Tanning
- Lithographing
- Medicines
- Mineral Feeds
- Neoprene Compounds
- Organic Synthesis
- Perfumes
- Pharmaceuticals
- Photographic Papers
- Rayon
- Refractories
- Refrigeration
- Road Binders
- Roofing
- Rubber Compounds
- Sedatives
- Textiles
- Water Softeners
- Weed Killers

OFFICERS

T. C. DAVIS	President
JOHN L. GILES	Vice-President and General Manager
ROBERT L. WILSON	Secretary
RUSSELL J. KNAPP	Treasurer
CLARENCE G. WOODS	Controller

DIRECTORS

T. C. DAVIS	ARTHUR ROEDER
JOHN L. GILES	GENE TUNNEY
C. N. JOHNS	WILMOT F. WHEELER

ROBERT L. WILSON

Transfer Agent: National Bank of Detroit, Detroit 32, Mich.

To the Stockholders 83

MICHIGAN CHEMICAL CORPORATION

The annual report of Michigan Chemical Corporation submitted herewith presents the financial position of the Corporation at December 31, 1946 and the results of its operations for the year then ended. The balance sheet, as well as profit and loss summary and statement of surplus are all as approved by the auditors, Ernst & Ernst.

During the year 1946 our sales reached a new high, which reflects an increase of 52% over those of the previous year. Sales and production plans for 1947 are geared to still greater volume.

Net earnings for 1946 after all charges amounted to $137,803 or 62c per share on the 221,862 shares issued and outstanding at the close of the year. This amount compares with net earnings for the previous year of $175,641. The 1946 figures are net of charges for income taxes in the amount of $56,400, while in 1945 there were no similar taxes on income principally because of amortization of emergency facilities.

Net working capital amounted to $749,157 at December 31, 1946, an increase of $385,839 over that of $363,318 at December 31, 1945. This increase was also accompanied by an increase in the ratio of current assets to current liabilities from 1.74 at the close of 1945 to 2.41 at the end fo 1946.

There has been no change during 1946 in depreciation rates nor in the corporation's policy with respect to depreciation.

Real estate, plants and equipment were increased in an amount, net of depreciation, of $391,097. This increase represented part of an aggressive expansion program started prior to the beginning of 1946 and included additional real estate, buildings for insecticide packaging, mixing agricultural insecticide formulations and maintenance shop, and new equipment for these and other production departments. Also the new research laboratories and pilot plant building, the construction of which began in 1945, were completed. This served to accelerate our research program, the results of which should begin to be reflected during 1947.

During 1946 our Pestmaster DDT insecticides were distributed nation wide and in a number of foreign countries. This required the organization of an extensive sales staff for our household as well as agricultural lines, and as a matter of course involved the expenditures of a considerable sum for advertising. Our plans and commitments were carefully considered but the protracted steel strike which delayed until early spring the receipt of containers, was not forseen. The acute shortage of raw materials which developed near midyear and become progressively worse as the year advanced, was likewise not anticipated. These two factors forced your Company to cancel a substantial amount of business secured by our live sales organization. Nevertheless we were able to definitely establish Pestmaster and substantially greater sales of these products are indicated for 1947. Your Company now offers the most complete line of DDT products to be found under one label.

The expansion of our sales and production with accompanying receivables and inventories, caused bank loans to advance to a peak of $450,000. Furthermore, your management had announced its intention of fully retiring the balance of the RFC loan which amounted to $246,521 at the beginning of the year. Also the expansion of plant facilities referred to earlier in this letter, were obviously necessary. Therefore on June 15, 1946 your Company sold privately and at par, $850,000 of 5-year debentures, convertible into common stock at $40 per share, and both bank and RFC loans were paid off.

Our aggressive expansion policy, prompted by certain research activity, caused your Board to authorize the acquisition by purchase of the adjoining 16-acre tract belonging to the Leonard Refinery Company and containing office building, steam plant, refinery equipment, extensive tankage, two small warehouses, laboratory building, as well as an excellent railroad siding. This property will gradually be utilized in the further expansion of your Company.

Due to the scarcity of raw materials and the expanding demand for our products your Company endeavored to lease from the Government certain chemical facilities located at Pine Bluff Arsenal. We are pleased to advise you that leases were finally consummated on February 12, 1947. We expect to be in production at this plant by May 1st and new products not heretofore made by your Company will be added as rapidly as the availibility of equipment and personnel will permit. The activities presently contemplated at Pine Bluff, Arkansas, will not require any permanent financing.

Before the close of 1946 the remaining 4,381 warrants were exercised. Also options representing 3,900 shares were exercised by employees and the remaining 2,475 shares were allocated to key employees, being the last of the 10,000 shares authorized by stockholders on March 21, 1944 to be sold to employees at $5 per share as part of a program to increase their proprietary interest in the progress of the Company.

It is hoped that this report, with accompanying information will permit a better understanding of your Company's operations and indicate its potential growth. Our consumer products will be on sale in your city this year and you can procure them with the confidence that they represent the finest that careful research, best available equipment, and trained personnel can provide.

The year 1946 presented many serious problems. However the Company made substantial progress and the program for 1947 embraces projects which if successful will bring much greater recognition to Michigan Chemical Corporation.

By order of the Board of Directors,

Saint Louis, Michigan
March 6, 1947

T. C. Davis

T. C. DAVIS, President

assets

BALANCE SHEET • DECEMBER 31 • 1946

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CURRENT ASSETS		
Cash		$ 92,908.57
Trade accounts receivable	$446,358.54	
Less reserve	25,000.00	421,358.54
Inventories — at lower of cost (first-in, first-out method) or market:		
Finished products	$221,733.82	
Work in process	28,343.94	
Raw materials	453,198.55	
Fuel and supplies	60,090.95	763,367.26
TOTAL CURRENT ASSETS		$1,277,634.37
INVESTMENTS AND OTHER ASSETS		
Preparatory costs in connection with leased plant at Pine Bluff, Arkansas	$ 37,125.55	
Cash surrender value of life insurance	7,800.00	
Equity in foreign enterprise	4,322.95	
Capital Stock of Michigan Salt Company (100% owned) — at cost	1,000.00	
Deposits, advances, and miscellaneous accounts	4,455.81	54,704.31
PROPERTY, PLANT, AND EQUIPMENT — at cost, less reserves for depreciation		
Land	$ 23,245.45	
Wells and reservoir	$ 126,290.39	
Buildings and other structures	344,169.57	
Machinery and equipment	794,878.21	
	$1,265,338.17	
Less reserves for depreciation	372,383.83	892,954.34
Construction in progress (estimated cost to complete — $150,000.00)	101,804.13	1,018,003.92
DEFERRED CHARGES		
Unexpired insurance premiums	$ 17,736.42	
Advertising materials and advances applicable to 1947 distribution	12,242.61	29,979.03
		$2,380,321.63

MICHIGAN CHEMICAL CORPORATION

51-9

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liabilities

BALANCE SHEET • DECEMBER 31 • 1946

CURRENT LIABILITIES		
Accounts payable:		
Trade accounts	$307,731.74	
Salaries, wages, and commissions	30,306.95	
Pay roll taxes and income taxes withheld from employees	19,263.94	
Miscellaneous liabilities	13,135.53	$ 370,438.16
Accrued interest and taxes		1,639.14
Federal and state taxes on income — estimated		56,400.00
Debentures to be retired June 15, 1947		100,000.00
TOTAL CURRENT LIABILITIES		$ 528,477.30
LONG-TERM DEBT — Note A		
Five-year 4% Convertible Debentures due June 15, 1951	$850,000.00	
Less debentures to be retired on or before June 15, 1947, through operation of sinking fund, classified as current liability	100,000.00	750,000.00
CAPITAL STOCK AND SURPLUS — Notes A and B		
Common Stock, par value $1.00 per share:		
Authorized 250,000 shares		
Unissued (of which 26,950 shares are reserved) 28,138 shares		
Issued and outstanding 221,862 shares	$221,862.00	
Capital surplus	727,313.45	
Earned surplus	152,668.88	1,101,844.33
		$2,380,321.63

NOTES TO FINANCIAL STATEMENTS

NOTE A — The Corporation is required, through the operation of a sinking fund, to retire Five-Year Convertible Debentures in the principal amount of $100,000.00 on or before June 15, 1947, at a premium of 2½%, and to retire debentures in the principal amount of $150,000.00 on or before June 15th of each succeeding three years at premiums of 2%, 1½%, and 1%, respectively. The debentures may be redeemed at any time at the option of the Corporation at corresponding premium rates. The debentures may be converted into Common Stock at the option of the holders at the rate of one share for each $40.00 of principal amount. Debentures acquired by the Corporation through redemption or conversion may be applied in satisfaction of the sinking fund requirements.

The Corporation has agreed that it will pay no dividends on the Common Stock so long as any debentures are outstanding.

NOTE B — On March 21, 1944, the Corporation reserved 15,000 shares of its Common Stock for sale to management and key employees on or before March 21, 1947, at $5.00 a share, the approximate market price at date of reservation. Rights to purchase 8,825 of such shares were allotted prior to 1946 and 5,400 shares were purchased. On January 2, 1946, a further allotment was made with respect to 3,950 shares, and during the year 1946 a total of 3,900 shares were purchased. Rights to purchase the remaining 2,475 shares were allotted on January 2, 1947.

The difference between the option price of $5.00 a share and the estimated fair value at date of allotment of the 3,950 shares as to which allotment was made in 1946 has been charged to profit and loss for the year.

At December 31, 1946, 5,700 shares of unissued Common Stock were reserved in connection with the aforedescribed allotments, and 21,250 shares were reserved for conversion of debentures as explained in Note A.

MICHIGAN CHEMICAL CORPORATION

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profit and loss summary

YEAR ENDED DECEMBER 31, 1946

Sales, less cost of products sold		$1,010,281.32
Expenses:		
Selling and advertising	$580,791.99	
Administrative and general	181,302.48	762,094.47
		$ 248,186.85
Other income		5,030.85
		$ 253,217.70
Other deductions:		
Interest expense	$ 27,415.14	
Charge in connection with allotment to employees of rights to purchase 3,950 shares of Common Stock at $5.00 a share	31,600.00	59,015.14
PROFIT BEFORE TAXES ON INCOME		$ 194,202.56
Taxes on income — estimated:		
Federal taxes	$ 64,000.00	
State taxes	2,400.00	66,400.00
		$ 127,802.56
Reduction in federal taxes on income because of operating loss carry-over from a prior year		10,000.00
NET PROFIT		$ 137,802.56

Provision for depreciation of property, plant, and equipment for the year amounted to $127,750.80.

See notes to financial statements.

statement of surplus

YEAR ENDED DECEMBER 31, 1946

CAPITAL SURPLUS:		
Balance at January 1, 1946		$662,603.95
Additions:		
Excess of selling price over par value of 8,281 shares of Common Stock sold during the year (including 3,900 shares sold to employees under stock options)	$33,124.00	
Excess of estimated fair value at allotment date over option price ($5.00 a share) of 3,950 shares of Common Stock as to which rights to purchase were allotted to employees during the year	31,600.00	64,724.00
		$727,327.95
Less excess of purchase price over par value of one-half share of Common Stock purchased		14.50
Balance at December 31, 1946		$727,313.45
EARNED SURPLUS:		
Balance at January 1, 1946		$ 14,866.32
Net profit for the year		137,802.56
Balance at December 31, 1946		$152,668.88

See notes to financial statements.

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ERNST & ERNST

Board of Directors,
Michigan Chemical Corporation,
Saint Louis, Michigan.

We have examined the balance sheet of Michigan Chemical Corporation as of December 31, 1946, and the statements of profit and loss and surplus for the year then ended, have reviewed the system of internal control and the accounting procedures of the Corporation and, without making a detailed audit of the transactions, have examined or tested accounting records of the Corporation and other supporting evidences, by methods and to the extent we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary.

In our opinion, the accompanying balance sheet and related summary of profit and loss and statement of surplus present fairly the position of Michigan Chemical Corporation at December 31, 1946, and the results of its operations for the year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

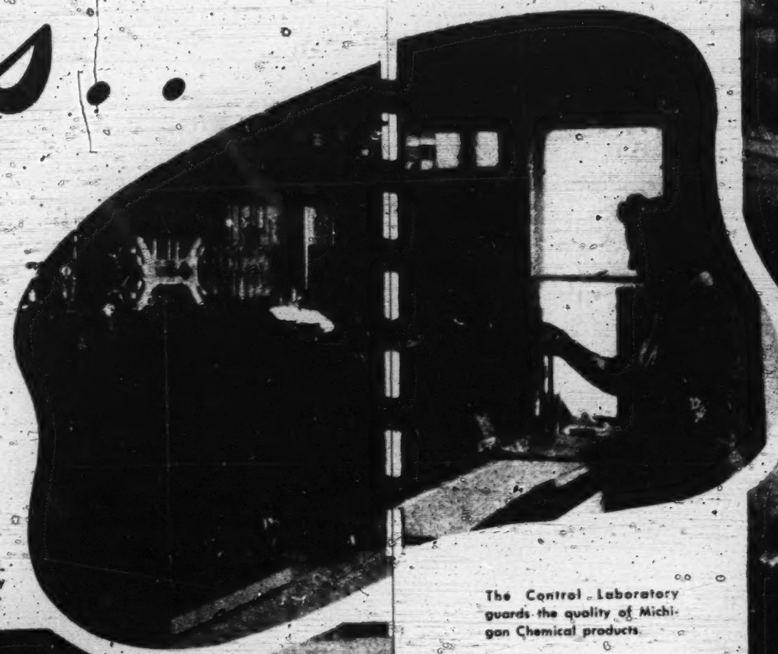
ERNST & ERNST
Certified Public Accountants

Grand Rapids, Michigan
February 24, 1947

Facilities . .

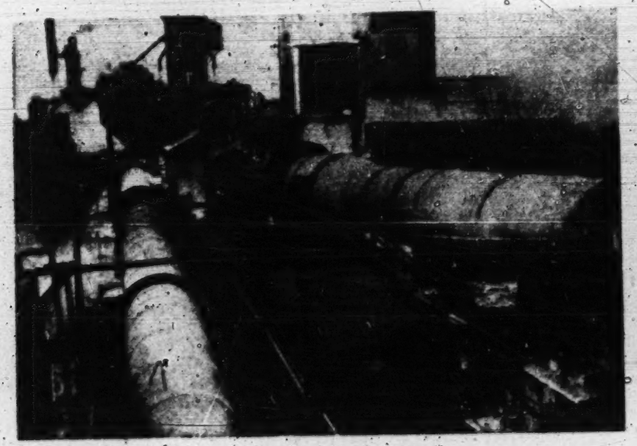
The Corporation's 14-acre site is now occupied by several manufacturing units with over a dozen large buildings, a number of smaller ones and extensive storage tank facilities. An adjacent 16 acres, recently purchased (from Leonard Refineries, Inc.) contains usable facilities and provides much needed room for expansion. The Corporation also owns 40 acres on the north side of the river which bounds the plant. Eleven brine wells, all within a 3-mile radius, furnish the plant's chief raw material.

During 1946, DDT manufacturing capacity was further augmented by a liquid compounding plant and an agricultural insecticide plant. The production capacity of technical grade DDT was increased by about 100 per cent. Important improvements were made in other operations, together with the introduction of several new processes.

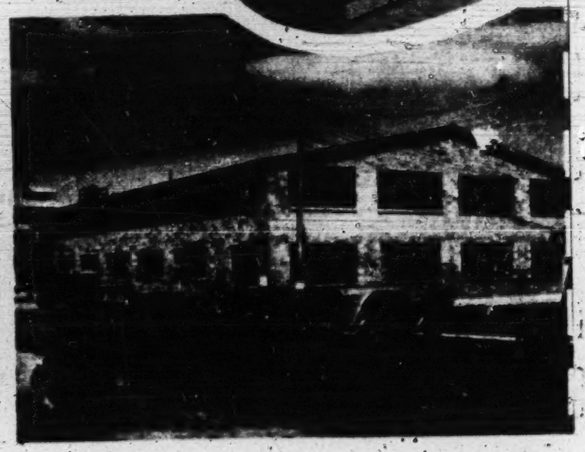


New Service Building (center background) now nearing completion.





These rotary kilns are part of our up-to-date Magnesia Plant.



Modern Compounding Plant recently placed in operation.

The Control Laboratory guards the quality of Michigan Chemical products.

General View of Michigan Chemical Corporation plant.



Facilities . .

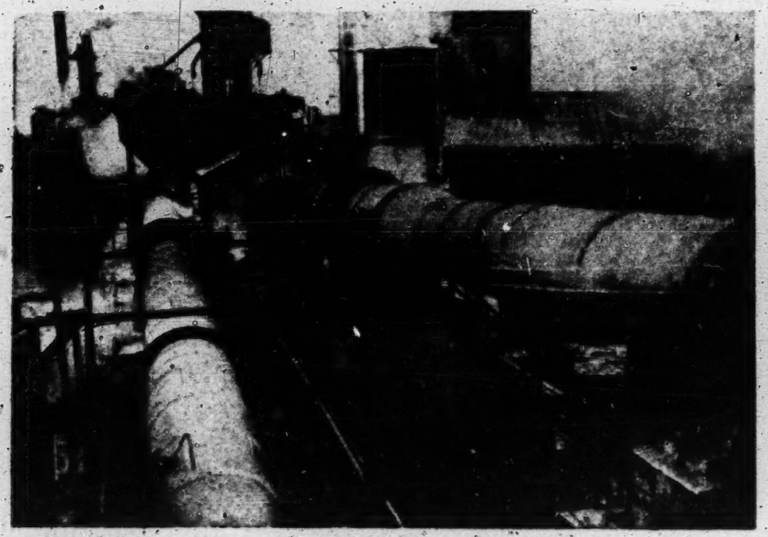
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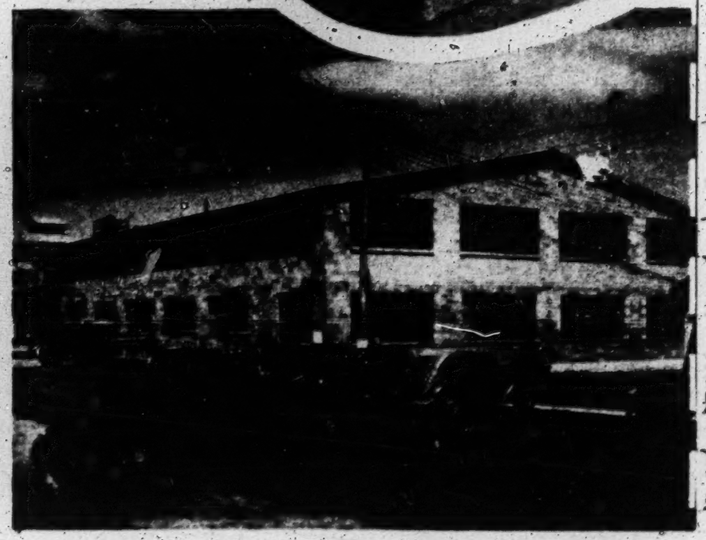


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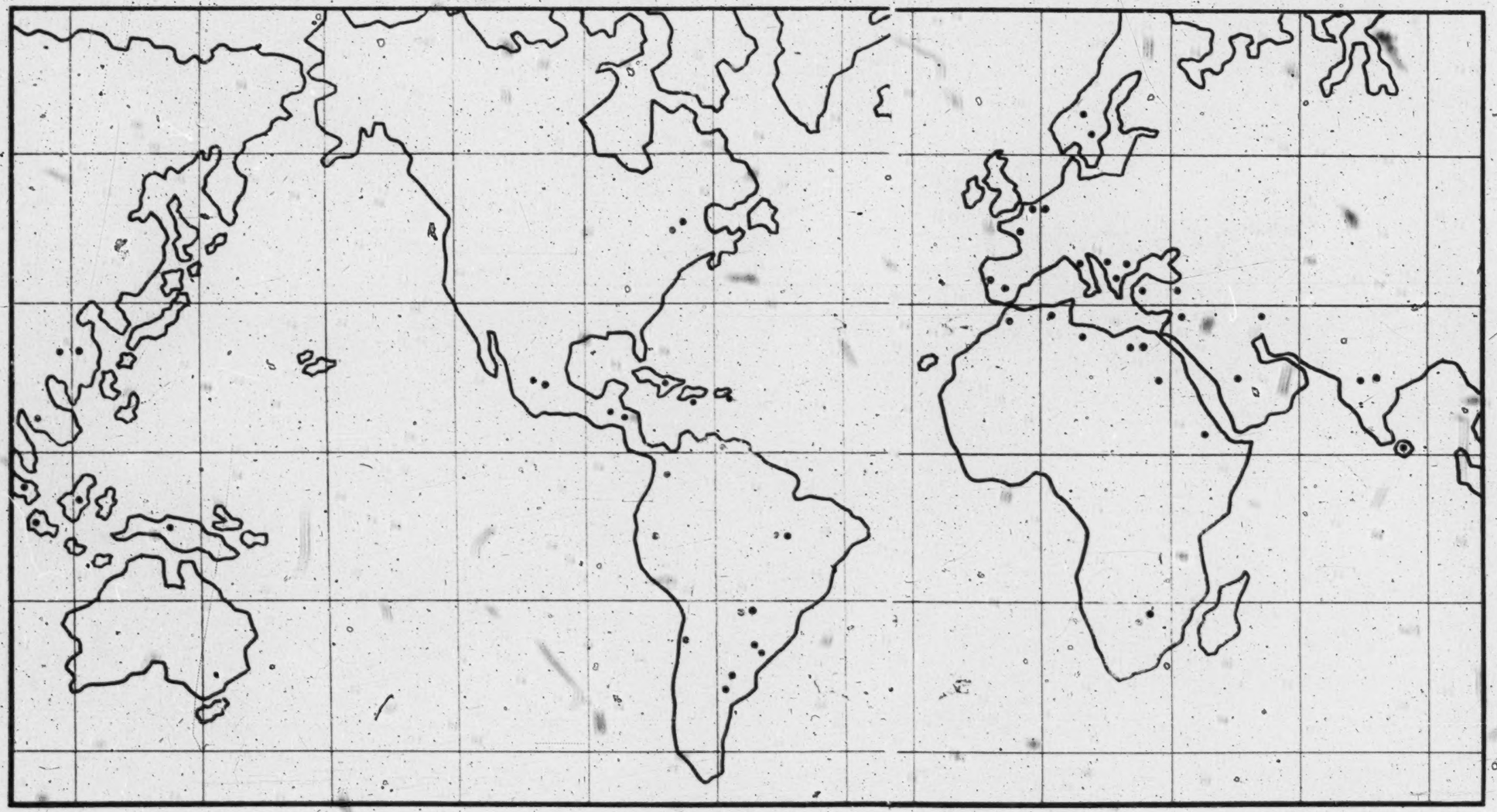


Modern Compounding Plant recently placed in operation.

The Control Laboratory guards the quality of Michigan Chemical products.

General View of Michigan Chemical Corporation plant.



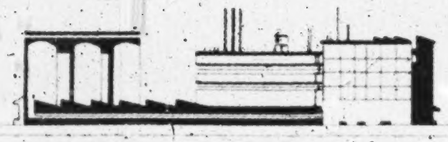


Michigan Chemical Products Go International

On the accompanying world outline map is shown in blue dots the countries into which Michigan Chemical insecticides and related products are being shipped in ever-increasingly important volume. Likewise, in black dots are shown the countries into which the pharmaceutical and industrial chemicals are being shipped.

As rapidly as time permits, a world wide distributor organization is being established. These distributors maintain direct contact with the Export Division of Michigan Chemical Corporation and purchase their requirements under Letter of Credit for direct shipment to them.





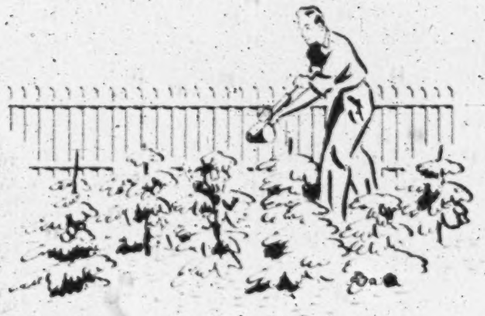






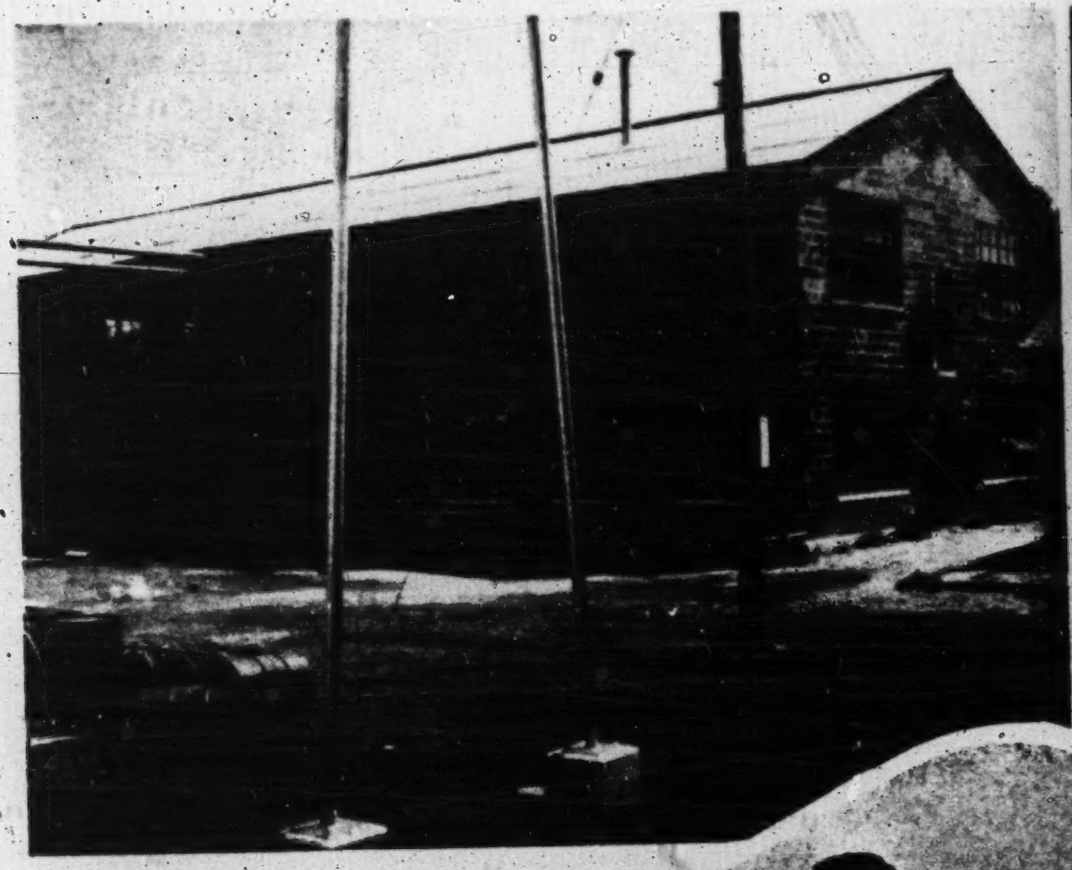
PESTMASTER

TRADE MARK

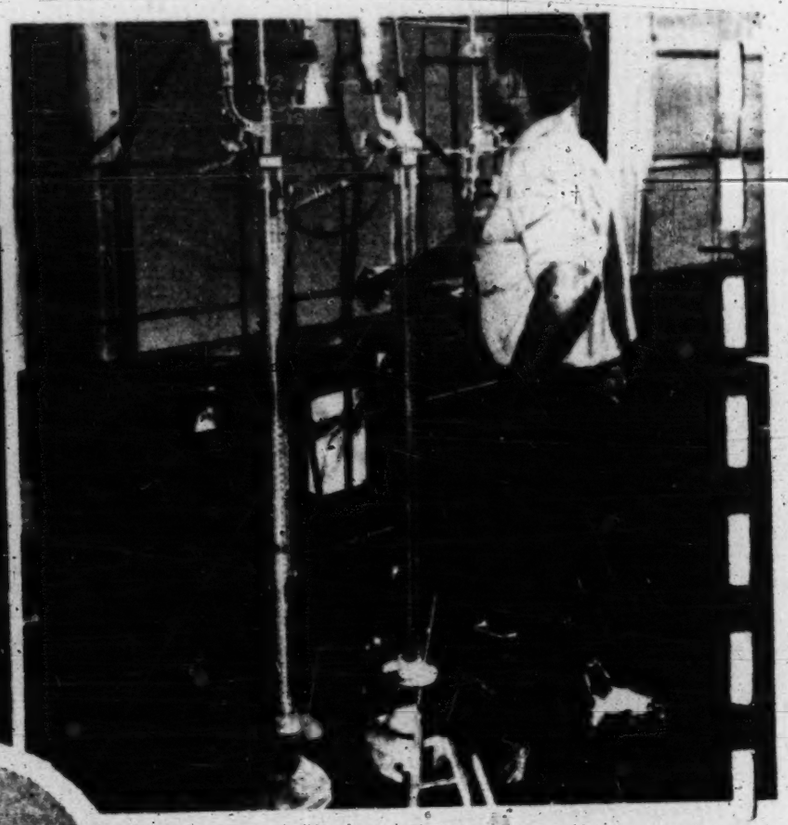


On the shelves of most drug stores and in thousands of hardware, grocery and farm supply stores throughout the length and breadth of this country, the PESTMASTER trademark is a now-familiar one. Attractively packaged, containing only the highest grade ingredients, it is a quality favorite.

PESTMASTER DDT has gone to work, ridding America's homes of annoying and disease-bearing insects; increasing agricultural production while improving its quality. PESTMASTER DDT has also proven a mighty factor in industrial sanitation, particularly in food processing, and in public health programs.



New Research Building, housing Laboratories and Pilot Plant.



Fractional distillation columns in the Organic Research Laboratory.

A search of the scientific literature is the first step in attacking a problem.



A Research Group in action. Teamwork solves today's complex problems.



Research

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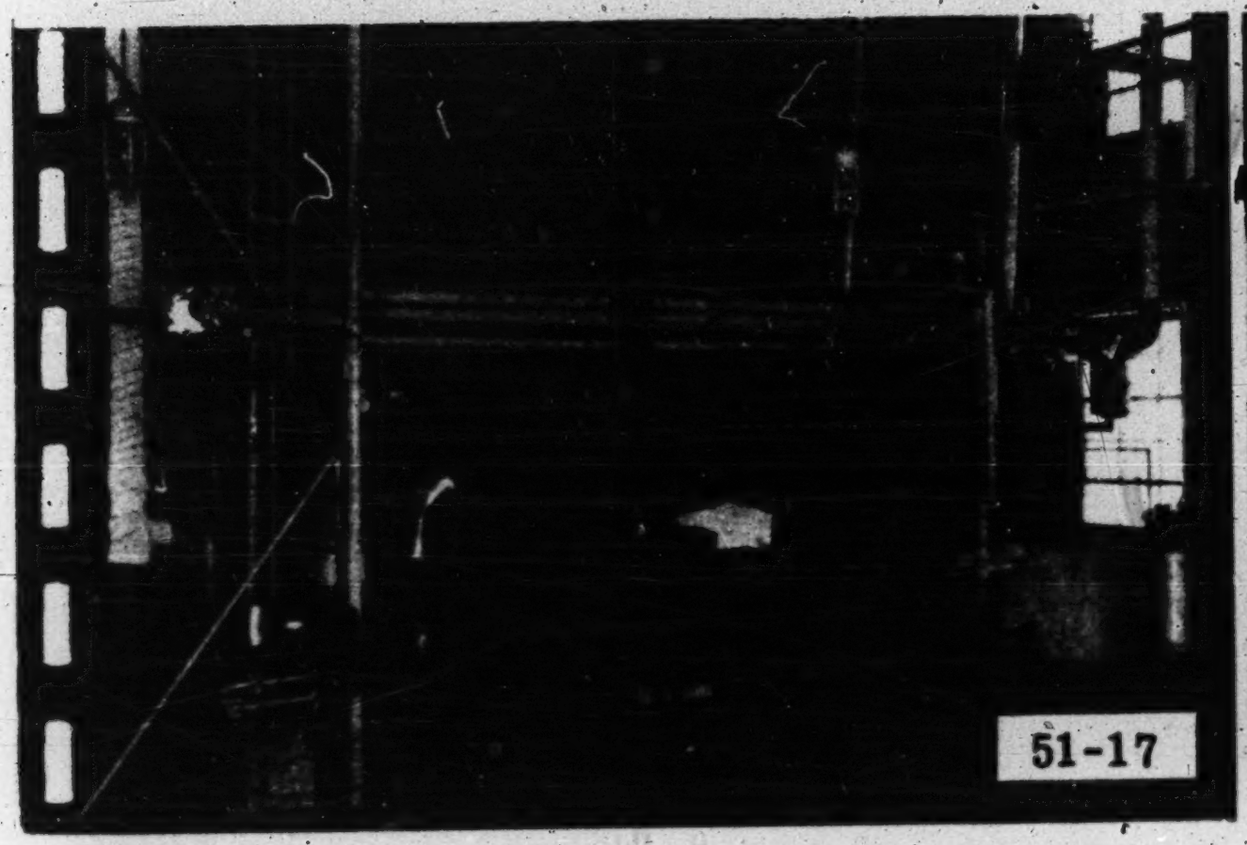
Early in 1946 the Technical Department, which includes all research and development activities, occupied a new 40 x 110 ft., two-story building. The new quarters comprise several laboratories, offices, conference room, library, facilities for the manufacture of fine chemicals, and an adequate pilot plant.

During the year Market Research was instituted; a Formula Compounding Laboratory and Entomological Research were added. Fellowships are maintained at leading colleges and research centers.

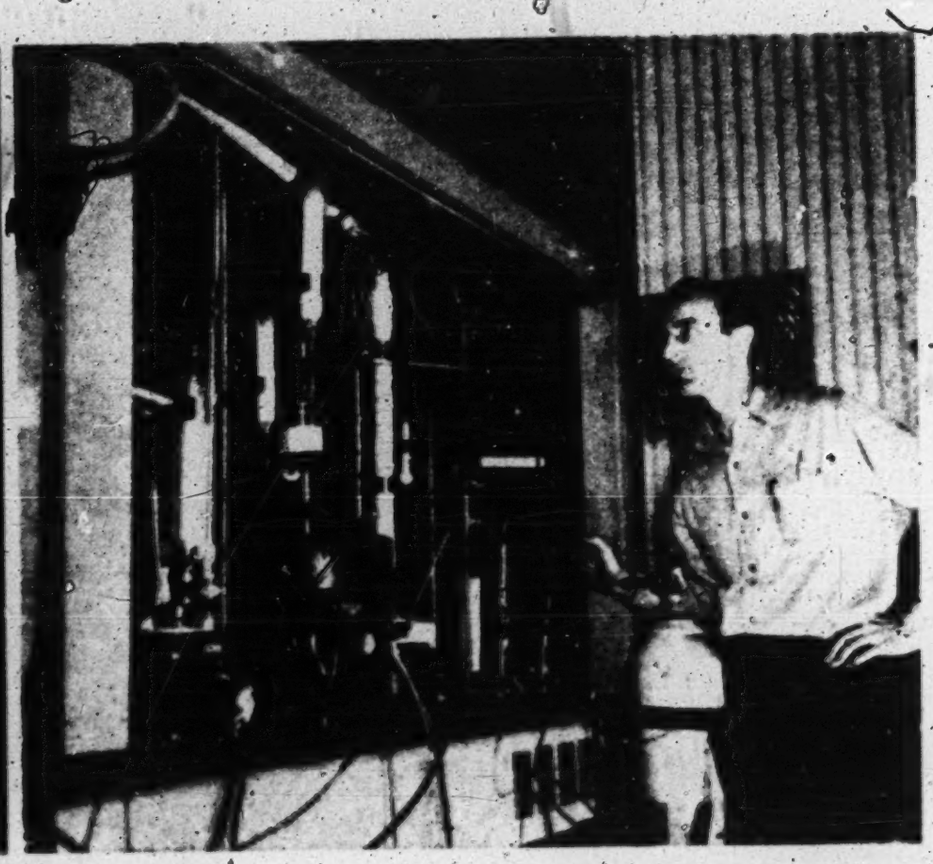
The present technical staff includes specialists in chemical engineering, organic and inorganic chemistry, entomology, process development, product application and use, market analysis and technical service.

A complete and integrated research program assuring the continued progress of our Company, is being carried out:

Thorough testing in the pilot plant precedes full scale manufacture.



Continuous improvement of our processes is a function of Research.



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For the Household

PESTMASTER DDT
Insecticides

WEEDMASTER 2,4-D
Weedicide

CRYSTAL FLOW
Table Salt

PESTMASTER, 3-in-1
Rose Treatment

For Agriculture

Granulated Salt and Salt Blocks

Methyl Bromide Fumigant

PESTMASTER DDT
Insecticides

WEEDMASTER 2,4-D
Weed Killers

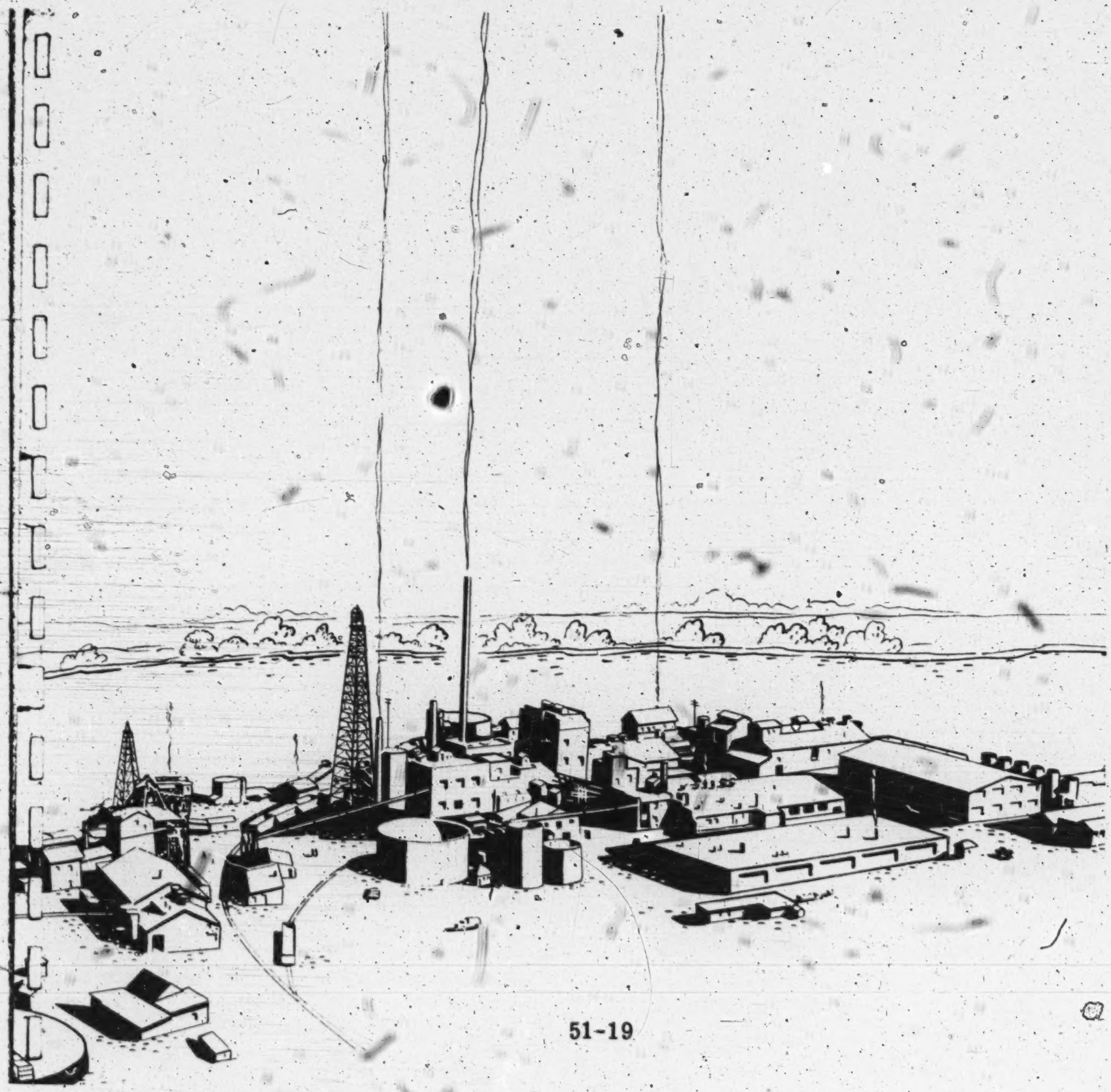
For Industry

Pharmaceutical Chemicals

DUSTMASTER
Liquid Chloride

PESTMASTER DDT
Insecticides

MICHIGAN
Magnesium Oxides



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MICHIGAN CHEMICAL CORPORATION

PLANT AND MAIN OFFICE • SAINT LOUIS, MICHIGAN

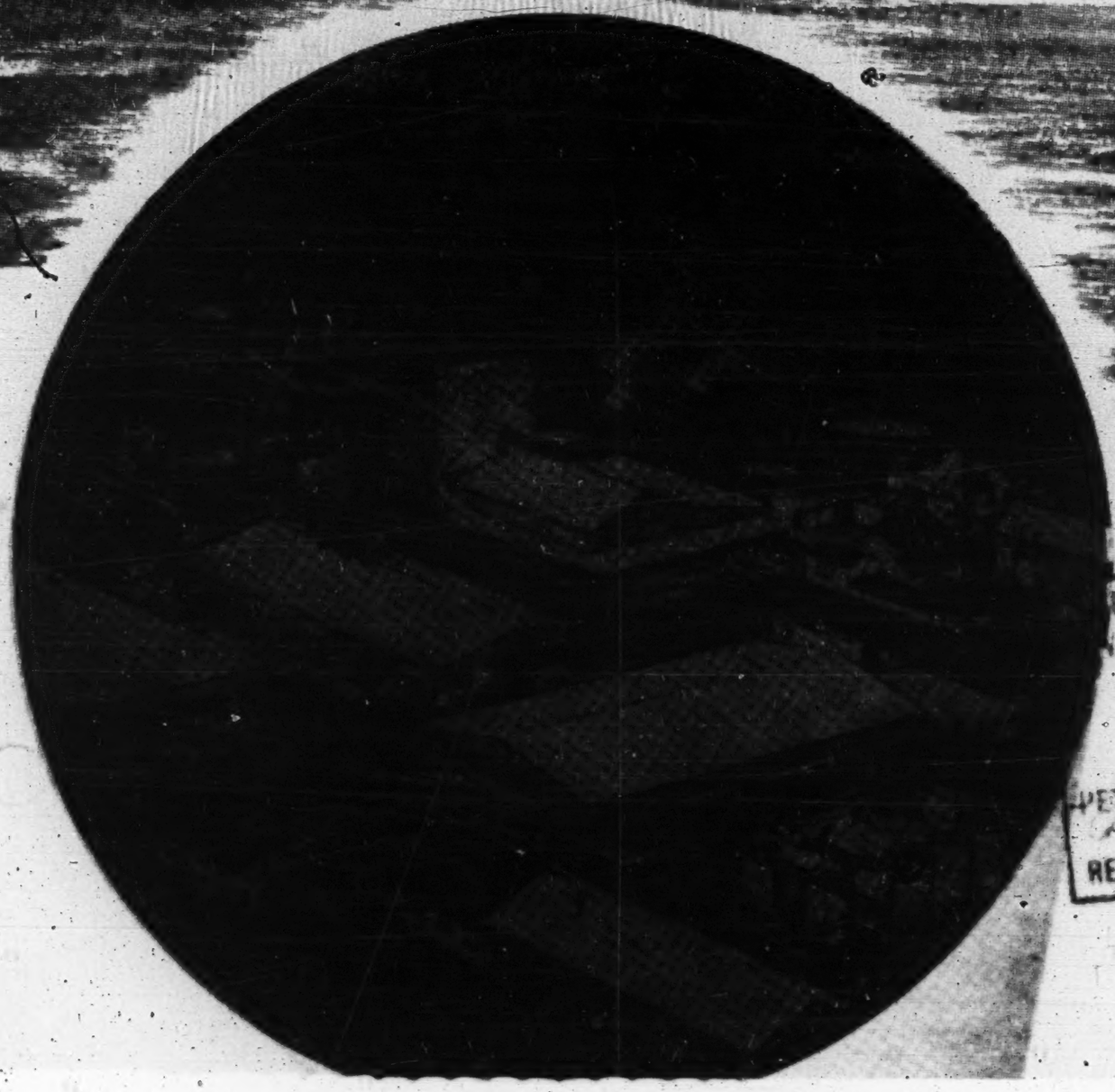
EASTERN SALES OFFICE, 230 PARK AVENUE, NEW YORK 17, NEW YORK
EXPORT DIVISION, SAINT LOUIS, MICHIGAN — CABLE ADDRESS "MICHEMCO"

51-20

PLASTIC BINDING PATENTS PENDING
MICHIGAN BOOK BINDING CO., DETROIT
PRINTED IN U.S.A.

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Exhibit 17



TAX COURT OF THE U.S.
ADMITTED
OCT 14 1953
PETITIONER'S
RESPONDENT'S

tion

TAX COURT OF THE U.S.
ADMITTED
OCT 14 1953.
PETITIONER'S EXHIBIT 17
RESPONDENT'S



Michigan Chemical Corporation

Annual Report

YEAR ENDED DECEMBER 31, 1947



Foreword

In this twelfth Annual Report your Company is presented in terms of its products, facilities, personnel, accomplishments, and objectives. Following the policy adopted in 1946 this report contains, in addition to the financial statements, illustrations, graphs, and other information designed to provide the fullest possible understanding of the Company's operations.

Tapping an inexhaustible natural brine deposit with its wells scattered throughout the countryside, Michigan Chemical Corporation is assured of a basic source of supply for its manufacture of a wide assortment of pharmaceutical, industrial and insecticidal chemicals. New and additional facilities established at Pine Bluff, Arkansas, furnish further assurance of a supply of raw materials and offer new possibilities of product expansion.

During 1947 new foreign as well as domestic markets were established for the Company's well-rounded line of intermediate and consumer products. Emphasis was placed on both the production and distribution of products having the greatest potentials.

Stimulated with the future possibilities of the chemical industry your Company proposes to improve its position with additional plant facilities, improved operation efficiencies, well-directed program of research and a sound marketing plan.

MICHIGAN CHEMICAL CORPORATION



Our Business

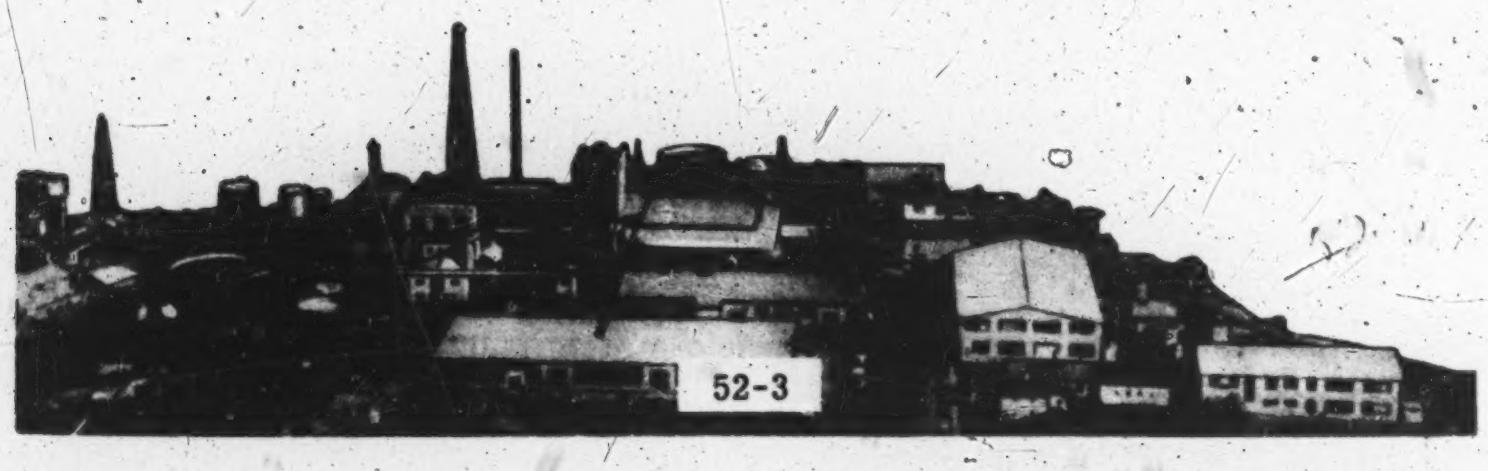
From four to forty different chemical products during the relatively short period of twelve years is one indication of the growth of your Company. Four principal elements—Bromine, Sodium, Calcium, and Magnesium, available in Central Michigan's natural brine deposits together with their derivatives form the basic source of supply for most of the products being manufactured today. From the standpoint of use they fall within the general classification of pharmaceutical, industrial, and insecticidal chemicals.

The Company's incorporation papers were filed in Michigan on February 21, 1935. The main plant, sales and executive offices are located at Saint Louis, Michigan. Three adjacent parcels of land total 70 acres and provide adequate area for present operation and future expansion. Pine Bluff Chemical Co., a jointly owned affiliate operates leased arsenal facilities at Pine Bluff, Arkansas.

Your Company's products enjoy national distribution with a substantial volume of business finding an increasing demand in many foreign countries. Sales offices are located in New York City and Kansas City, Missouri. For the customer's convenience and to effect savings in transportation cost, warehouses are maintained at Jersey City, Atlanta, Houston, Los Angeles and San Francisco.

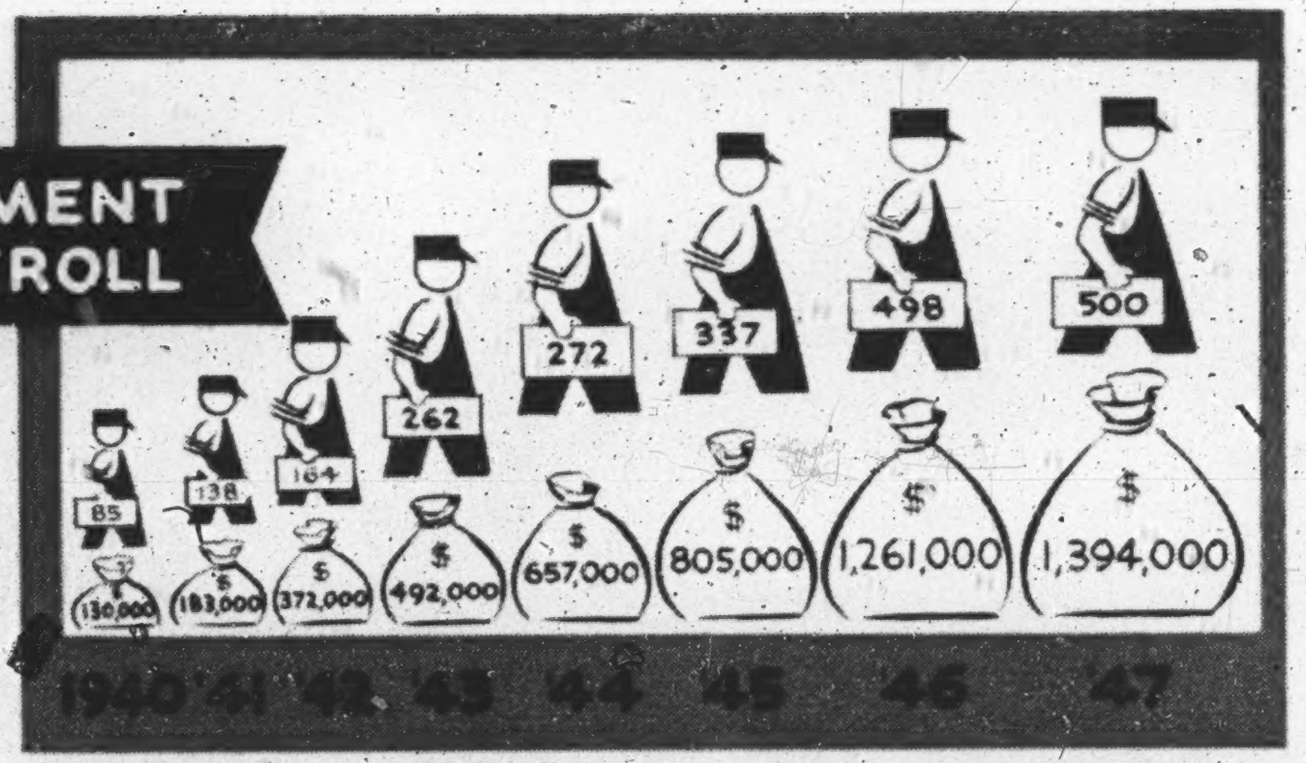
Sales of all products are made by Company personnel specializing in their particular line and are supported by well-directed advertising and technical information. Potential markets are researched continually and a New Products Committee meets frequently to discuss the manufacture and distribution of additional items.

Emphasis is placed on employee safety and welfare. An annual picnic is the highlight of the social side. An employee suggestion system furnishes many ideas for improvement of working conditions. During the past year the Group Insurance Plan was liberalized. This plan offers life, sickness and accident, plus hospital and surgical insurance to all eligible employees at low cost.



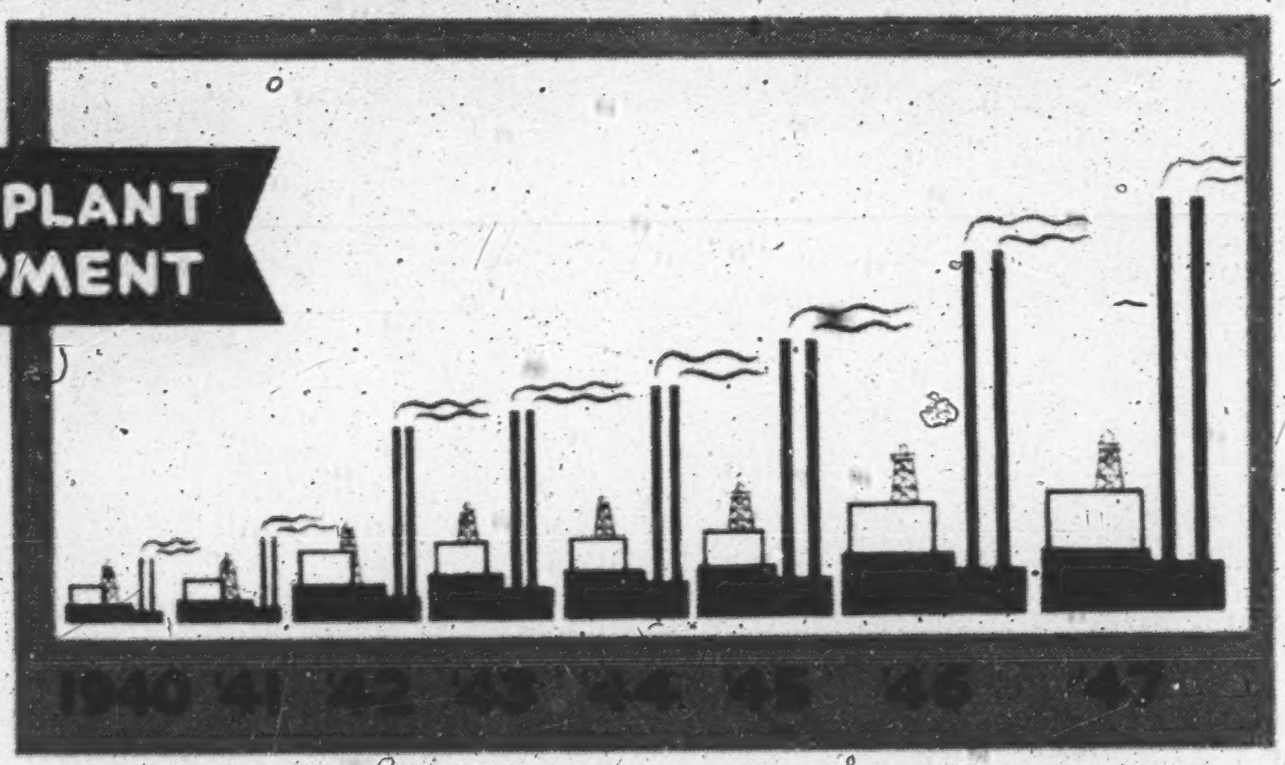
EMPLOYMENT AND PAYROLL

Employment and pay roll in 1947 were at an all time high. In that year 500 employees shared total wages amounting to $1,394,000.

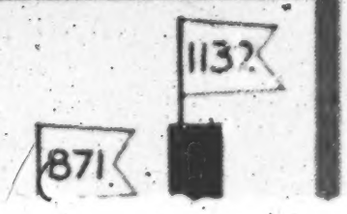


PROPERTY, PLANT AND EQUIPMENT

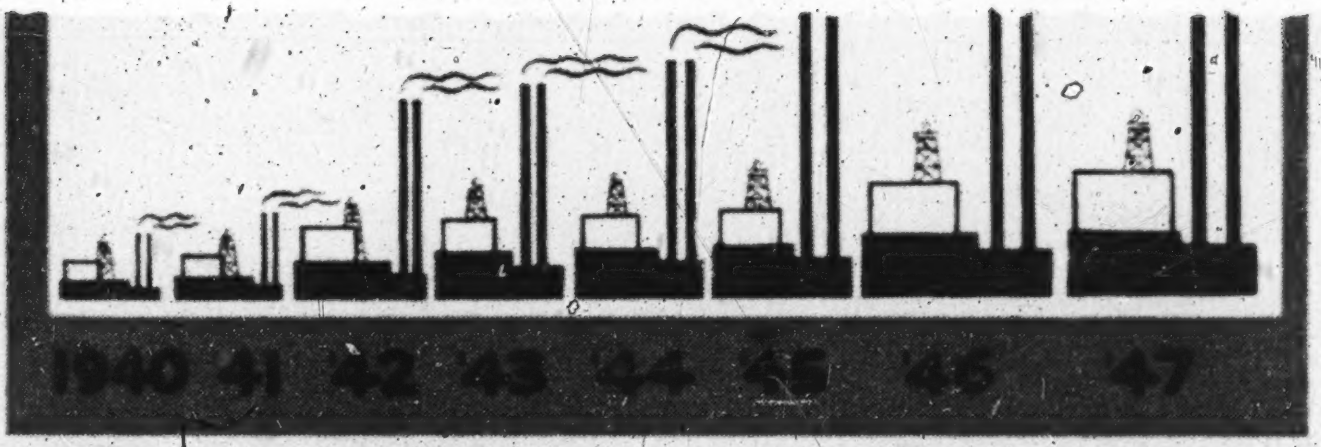
Present day reproduction costs of our plant and facilities are estimated to be several times book value.



NUMBER OF

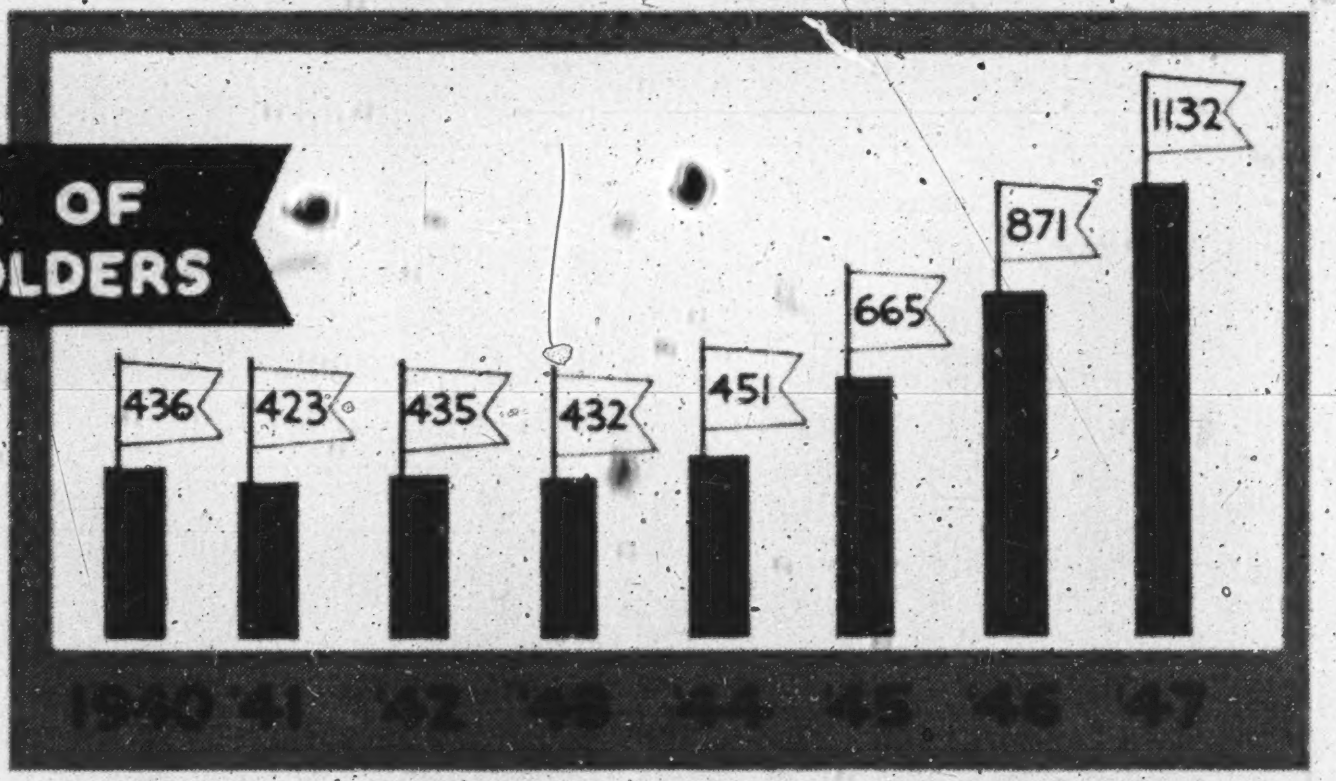


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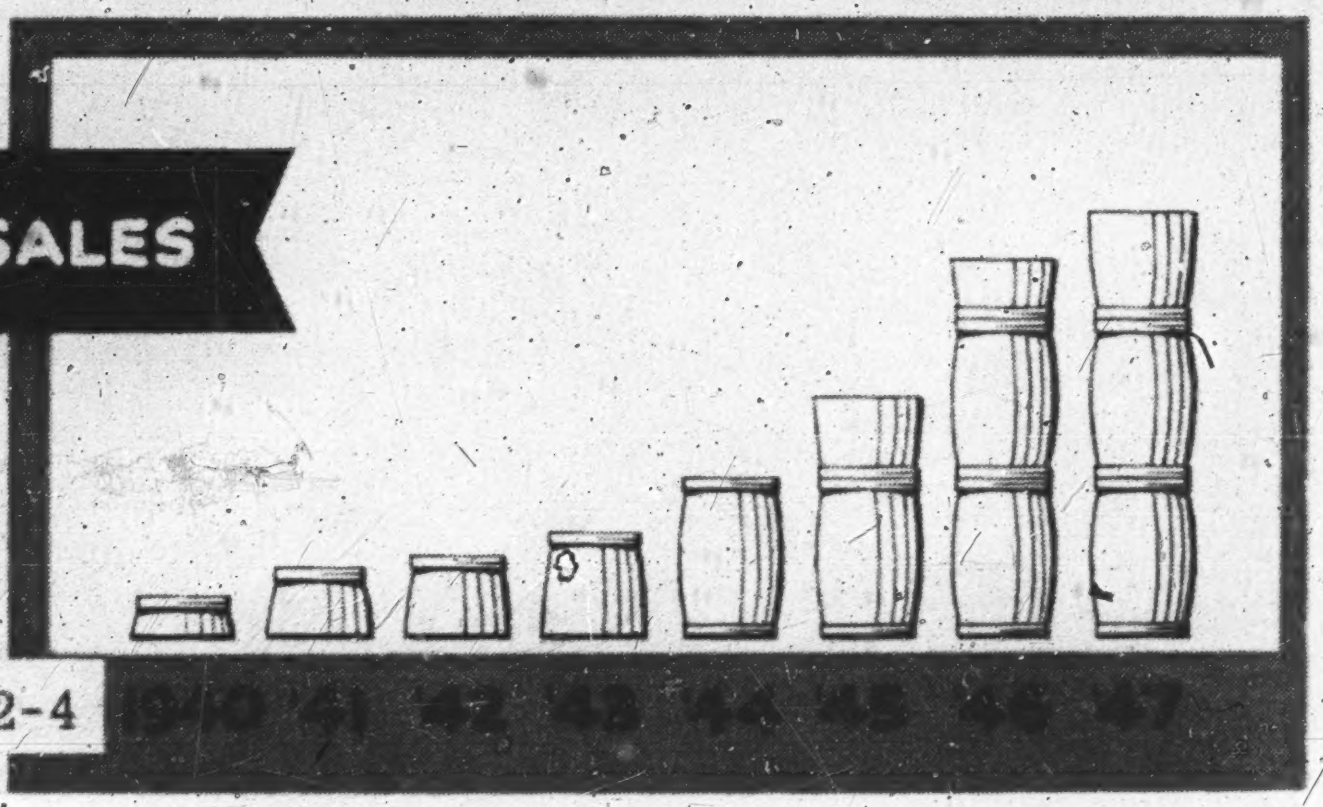
NUMBER OF STOCKHOLDERS

The ownership of Michigan Chemical Corporation is widely distributed geographically. In December of 1947 there were 1,132 stockholders as compared to 451 in 1944.



GROSS SALES

Sales of products have shown increases for every year of the Company's existence. Gross sales in 1947 were approximately 651% of the 1940 total.



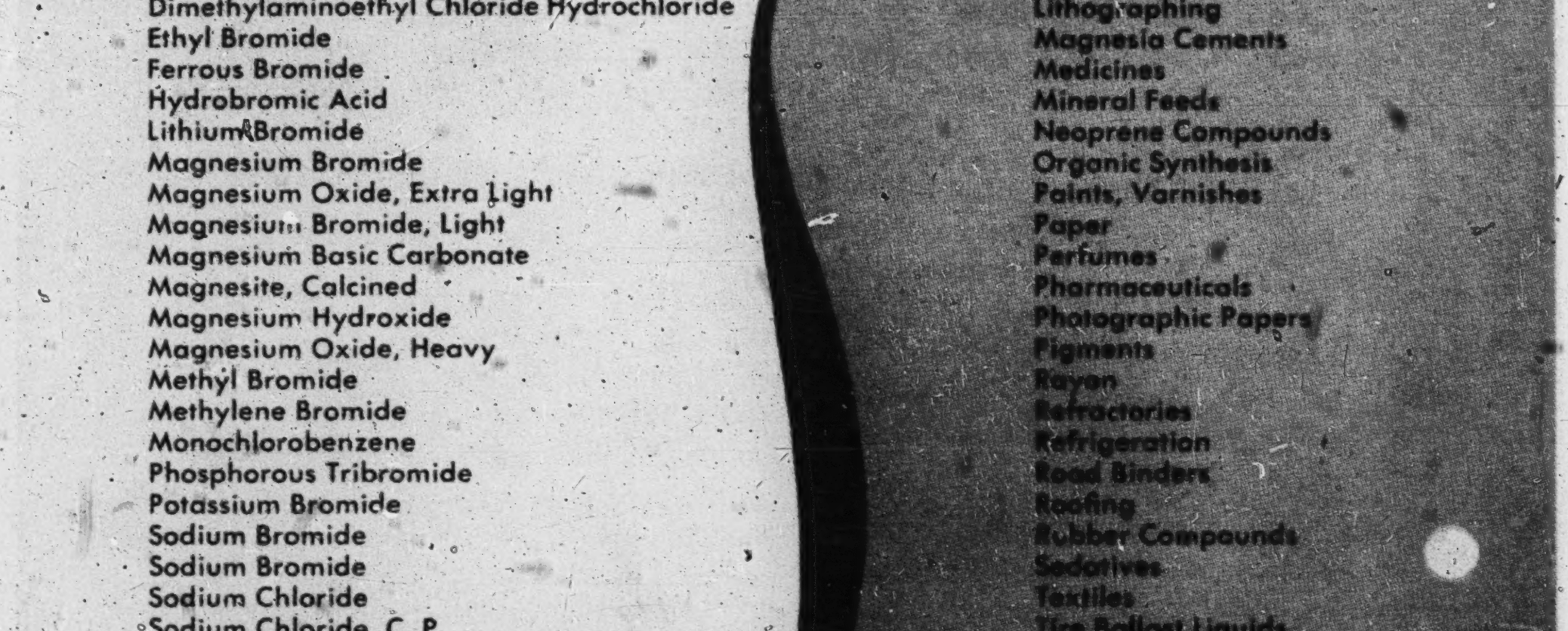
PRODUCTS

Allyl Bromide
Aluminum Bromide Anhydrous
Ammonium Bromide
n-Amyl Bromide
Barium Bromide
Bromine
Bromoform
2-Bromothiophene
n-Butyl Bromide
Calcium Bromide
Calcium Magnesium Chloride, Liquid
Chloral
CB* (Chlorobromomethane)
2-Chlorothiophene
DDT (Dichloro-diphenyl-trichloroethane)
2,4-D (2,4-Dichlorophenoxyacetic Acid) Sodium Salt
2,4-D (2,4-Dichlorophenoxyacetic Acid) Triethanolamine Salt
2,5-Dichlorothiophene
Diethylaminoethyl Chloride Hydrochloride
Dimethylaminoethyl Chloride Hydrochloride
Ethyl Bromide
Ferrous Bromide
Hydrobromic Acid
Lithium Bromide
Magnesium Bromide
Magnesium Oxide, Extra Light
Magnesium Bromide, Light
Magnesium Basic Carbonate
Magnesite, Calcined
Magnesium Hydroxide
Magnesium Oxide, Heavy
Methyl Bromide
Methylene Bromide
Monochlorobenzene
Phosphorous Tribromide
Potassium Bromide
Sodium Bromide
Sodium Bromide
Sodium Chloride
Sodium Chloride, C. P.
Strontium Bromide
Zinc Bromide

*Trade Mark of Michigan Chemical Corporation.

USES

Analytical Reagents
Anaesthetics
Antiknock Compounds
Ceramics
Coal Treatment
Dehydrating Agents
Dust Palliatives
Dyes
Engraving
Fire Extinguishers
Food Products
Fumigants
Glass
Glue
Growth Regulators
Inks
Insecticides
Insect Repellents
Insulation
Intermediates
Leather Tanning
Lithographing
Magnesia Cements
Medicines
Mineral Feeds
Neoprene Compounds
Organic Synthesis
Paints, Varnishes
Paper
Perfumes
Pharmaceuticals
Photographic Papers
Pigments
Rayon
Refractories
Refrigeration
Road Binders
Roofing
Rubber Compounds
Sedatives
Textiles
Tire Ballast Liquids
Water Softeners
Weed Killers



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MICHIGAN

Chemicals . . . .

Products of Michigan Chemical Corporation are among the basic necessities to present day standards of living. Our more than 40 different chemicals, most of them made in several grades, strengths, or formulations, constitute a well-diversified line.

Maintaining Michigan Chemical's position as a foremost producer of DDT, a completely new formulation, known as Colloidal Dispersion DDT, was offered for experimental testing in June, 1947. The PEST-MASTER trademark, familiar in every state, identifies our most complete line of agricultural and household insecticides. These are compounded from our high-grade technical DDT, a material which meets or exceeds all specifications which have been established for this chemical.



Emphasis on production of bromine derivatives continues, with six new ones added during the past year. At least two of these have good prospects of developing into tonnage items.

The manufacture of magnesia compounds, especially in the higher technical grades, is an important phase of Michigan Chemical's operation. The various types of magnesium oxide have many special uses, any one of which may require a product with particular physical properties or certain degree of purity. Full-scale production of magnesium hydroxide was achieved during the year. All magnesia products are derived directly from our raw material, brine.

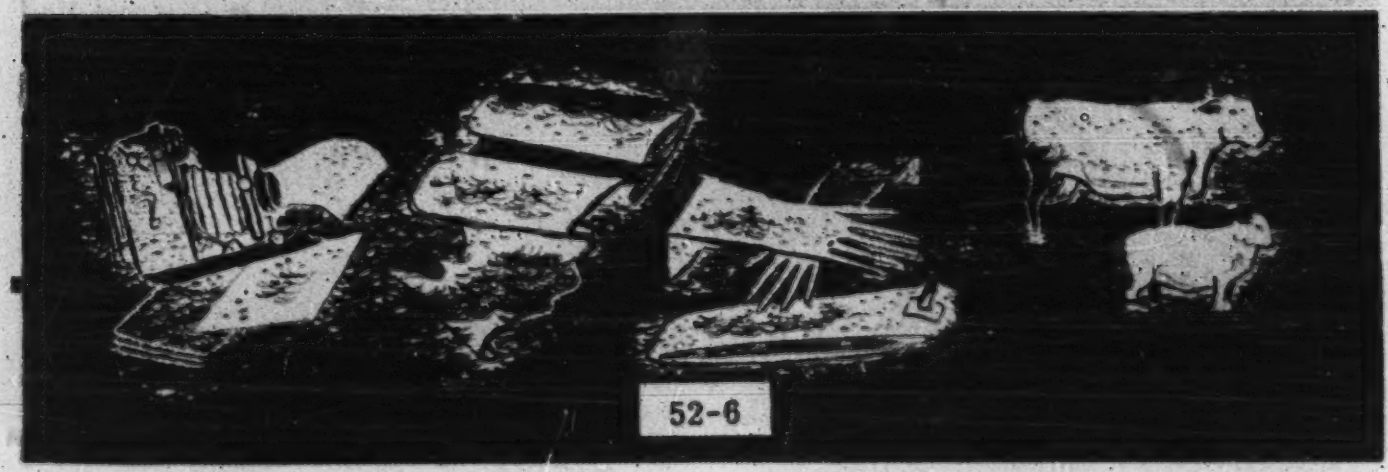


Capacity production of evaporated salt continued throughout the year. The output of the plant is marketed by Michigan Salt Company, our wholly-owned subsidiary, under its own trademarks, CRYSTAL FLOW, RED BAG and GOLD MEDAL, and under many private labels.

Michigan Chemical has been active in the introduction of 2,4-D weedkiller, anticipating the rapidly-expanding use of this chemical. Our WEED-MASTER brand is compounded for agricultural and home use.



Among other products made for the first time in 1947 were new fire extinguisher liquids, insecticides, pharmaceutical intermediates and thiophene derivatives.



Facilities . .

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The Corporation's plant site now comprises 30 acres along Pine River, with manufacturing units, storage tanks, laboratories, offices and powerhouse occupying a considerable portion of this area. There is sufficient room for expansion during the next few years. In this connection the Company owns an additional 40 acres of land immediately across the river.

The construction of new chlorinator and refrigeration units and the installation of additional packaging equipment have made our DDT plant among the most modern in the industry. The Agricultural Insecticides Department's capactiy was augmented by sizeable additions to building and equipment.

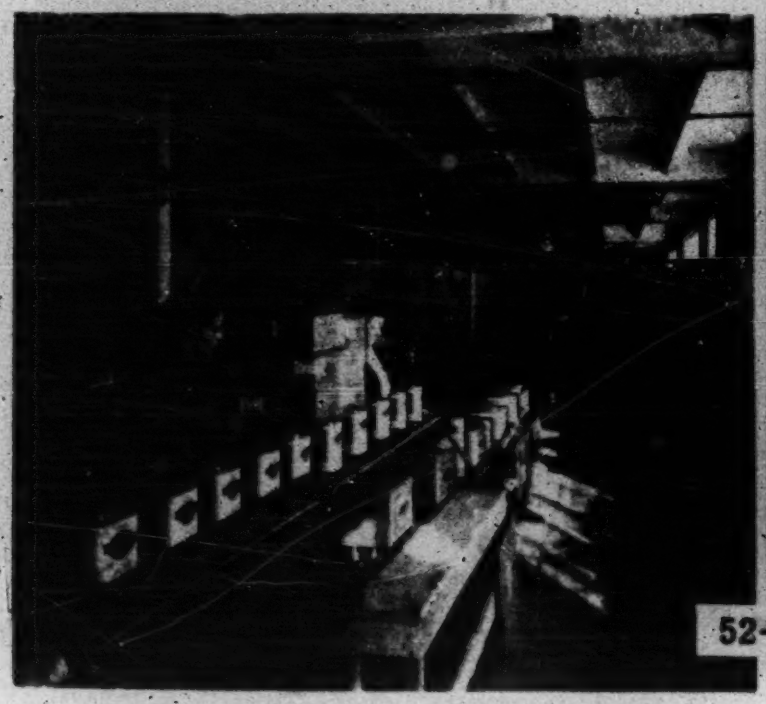
Magnesia capacity was also increased, particularly for the finer grades.

The new Organic Chemicals Building was nearly completed at the end of 1947, coinciding with the introduction of new products from our Research Laboratories. Steam and power capacity have been increased and a new sub-station has recently been installed by the Consumers Power Company to take care of our constantly increasing power demand.

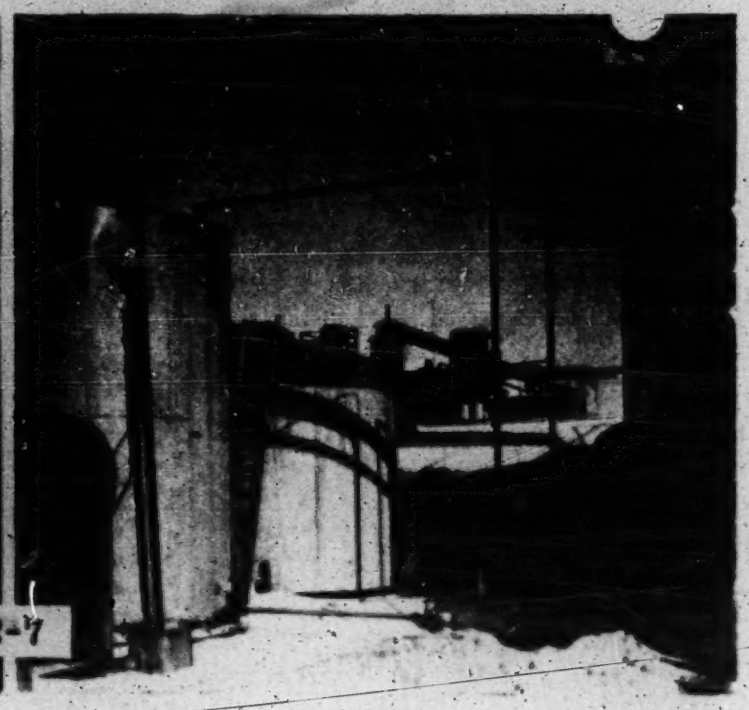
Calcium-magnesium chloride storage capacity now totals several million gallons, sufficient to take care of rush seasons. Production of the Corporation's brine wells was increased by the installation of improved pumping equipment.

A centrally-located service building was placed in use during the year and houses a machine shop, welding shop, electric shop and stock room.

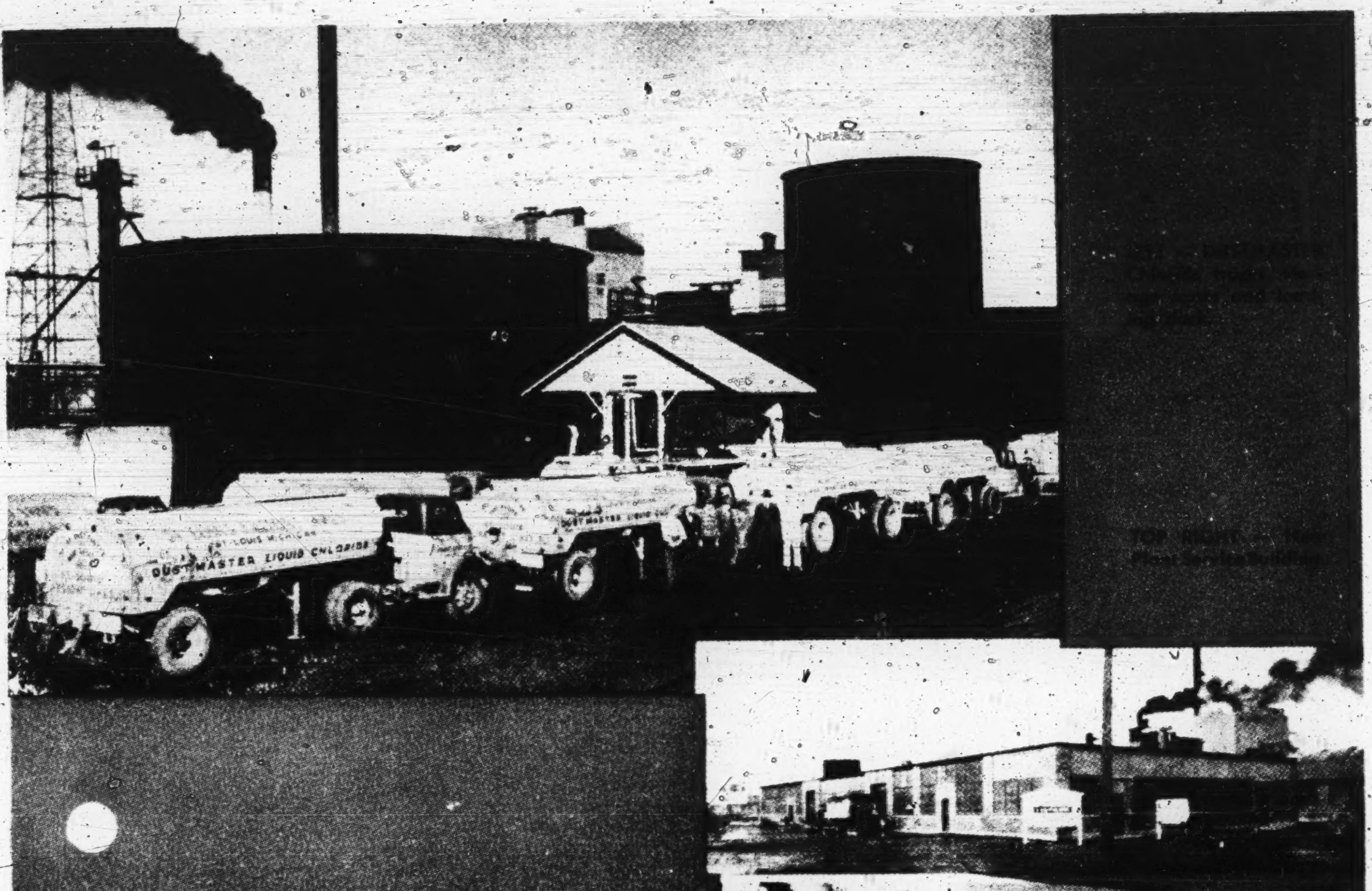
Packaging PESTMASTER Insecticides for household use.



Raw material storage tanks, DDT Plant.

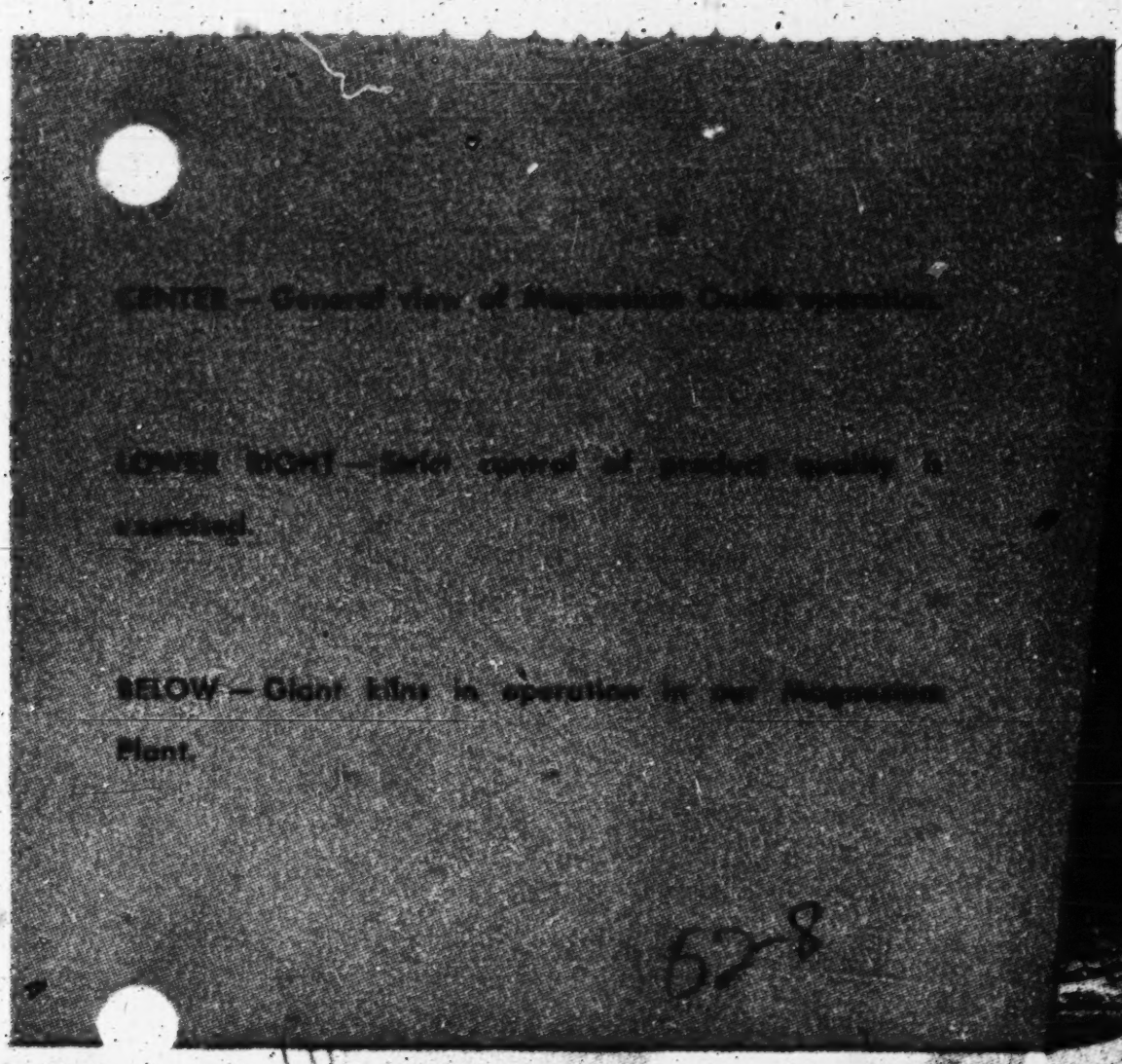


52-7



CENTER — General view of Magnesium Oxide operation.

LOWER RIGHT — Strict control of product quality is exercised.



CENTER — General view of Magnesium Oxide operation.

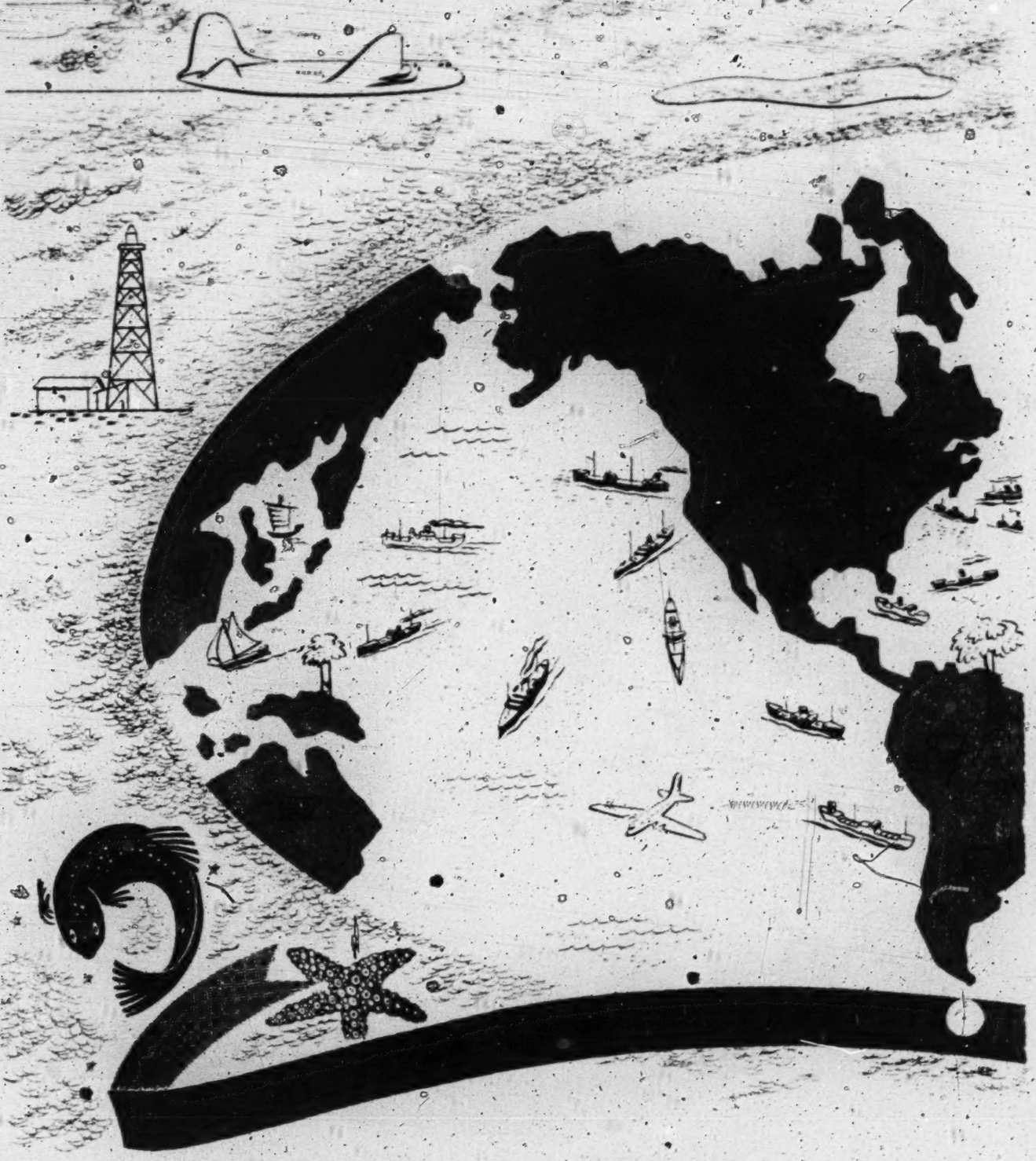
LOWER RIGHT — Strict control of product quality is exercised.

BELOW — Giant kilns in operation in our Magnesium Plant.

52-8

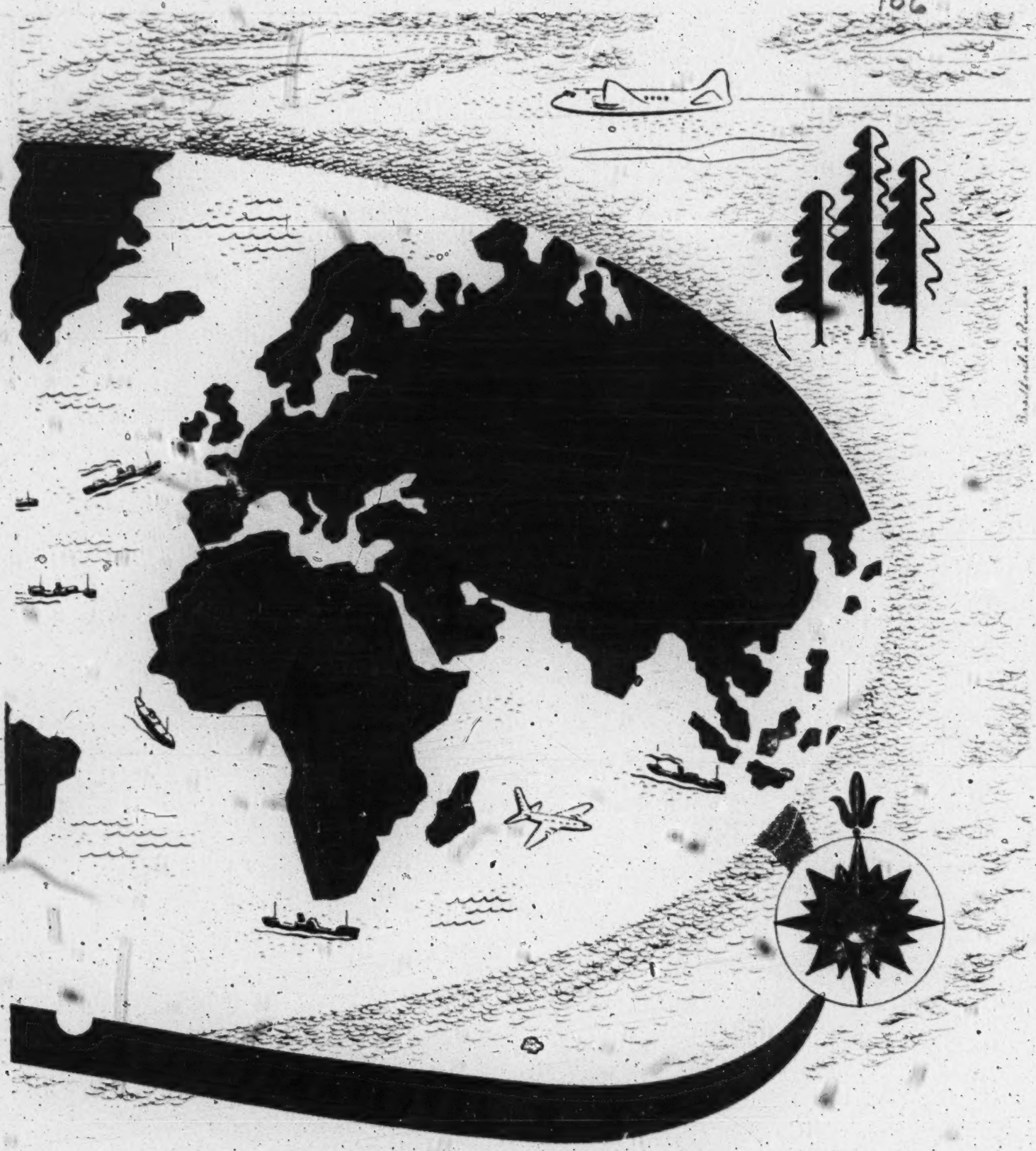


52-8



1947—A YEAR OF CONTINUED MICHIGAN CHEMICAL CORPORATION EXPORT EXPANSION

The year of 1947 registered important gains in Michigan Chemical Corporation's overseas program. New distributors, merchandising our trade-named products, were appointed in many Export markets and a world-wide program of education of these distributors and of the consumer in the correct use of Michigan Chemical's new insecticide, weedicide, and pharmaceutical products was conceived and put into execution.



Even though Export trade at the beginning of 1948 faces many serious problems, such as dollar shortages, export licensing, and import restrictions, it would seem safe to predict another successful year for Michigan Chemical Corporation's Export effort because it is based upon the distribution of products which are deemed as essential to greater health and increased food production. In all markets of the world, and, to the greatest extent, our efforts have been specifically extended along lines that will assure a measure of success in circumventing unfavorable conditions.


MASTER
WEEDMASTER
PESTMASTER
DUSTMASTER
BUGMASTER
MASTER
MASTER
PESTMASTER
WEEDMASTER
ROACHMASTER
kills
Crystal Flo
IODIZED
SALT
MICHIGAN
No. 15
Red Bag
SALT
PESTMASTER
WITH DOT
PESTMASTER
kills


MASTER
PESTMASTER
DUSTMASTER
BUGMASTER
MASTER
MASTER
PESTMASTER
WEEDMASTER
ROACHMASTER
kills
Crystal Flo
IODIZED
SALT
MICHIGAN
No. 15
Red Bag
SALT
PESTMASTER
WITH DOT
PESTMASTER
kills

52-11

Research

During 1947 the Technical Department, which includes Research and Development, carried on a full and integrated program resulting in the introduction of a number of new products. Among these was a new and exclusive formulation of DDT, for which a patent application is in process; new specialty bromides, thiophene compounds and fire-extinguisher chemicals. Further improvement was achieved in several of our present processes.

A full staff of engineers, chemists, technicians and laboratory assistants carries on the work of the Research Department.

Facilities are adequate and consist of five laboratories, five offices, a library, a pilot plant, and fine chemicals department. The Department's activities are divided into inorganic, organic and anayltical chemistry, formula compounding, entomology and development. Industrial fellowships are sponsored at leading universities.

A relatively smaller number of large projects, requiring one to five years for completion, are under way. Most of these will result in major developments and are vital to the continued health and growth of the business.

In present day practice it is frequently necessary to follow a product into the field, study its uses, and render various services to the customer. The scope of the Technical Department includes technical field service, market development and analysis, and technical publications.

DDT, for which a patent application is in process; new specialty bromides, thiophene compounds and fire-extinguisher chemicals. Further improvement was achieved in several of our present processes.

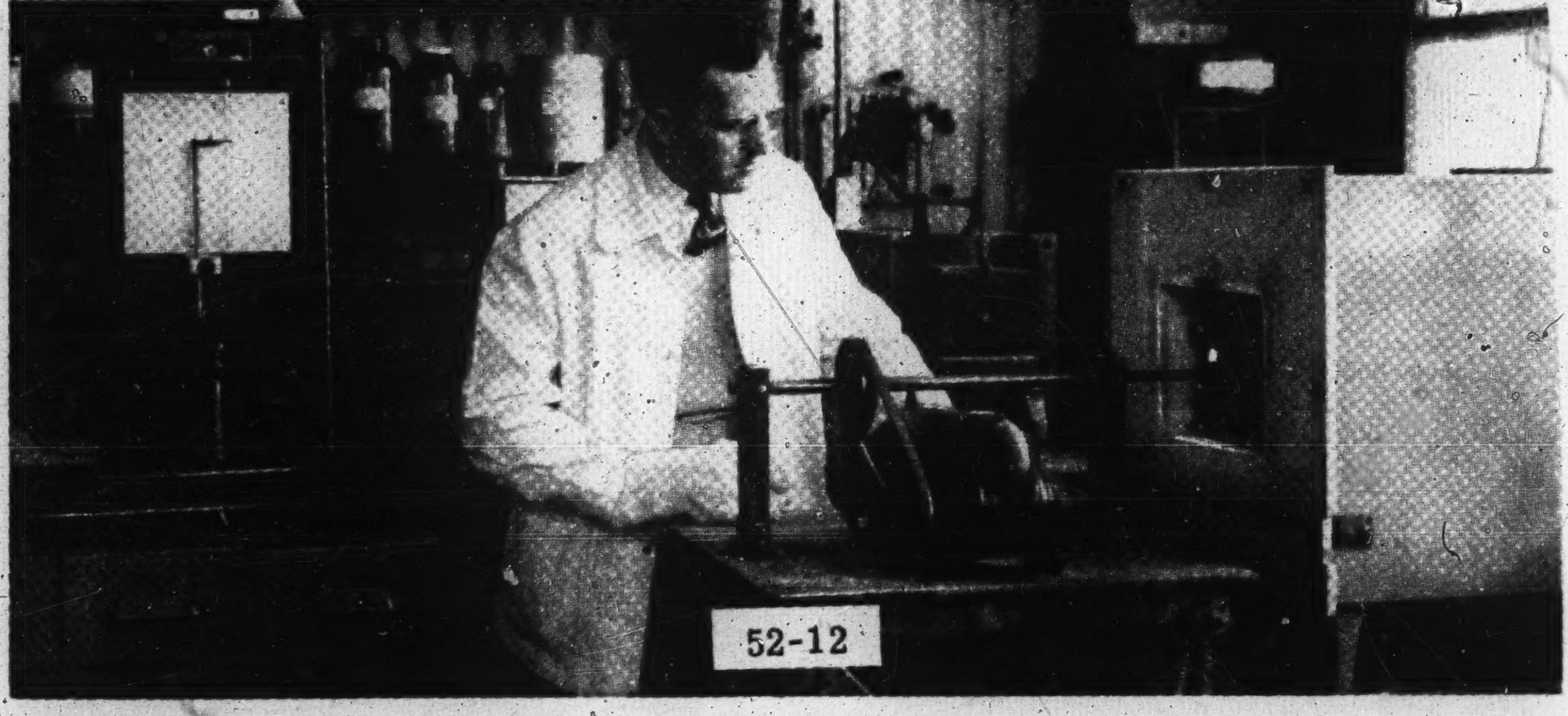
a pilot plant, and fine chemicals department. The Department's activities are divided into inorganic, organic and anayltical chemistry, formula compounding, entomology and development. Industrial fellowships are sponsored at leading universities.

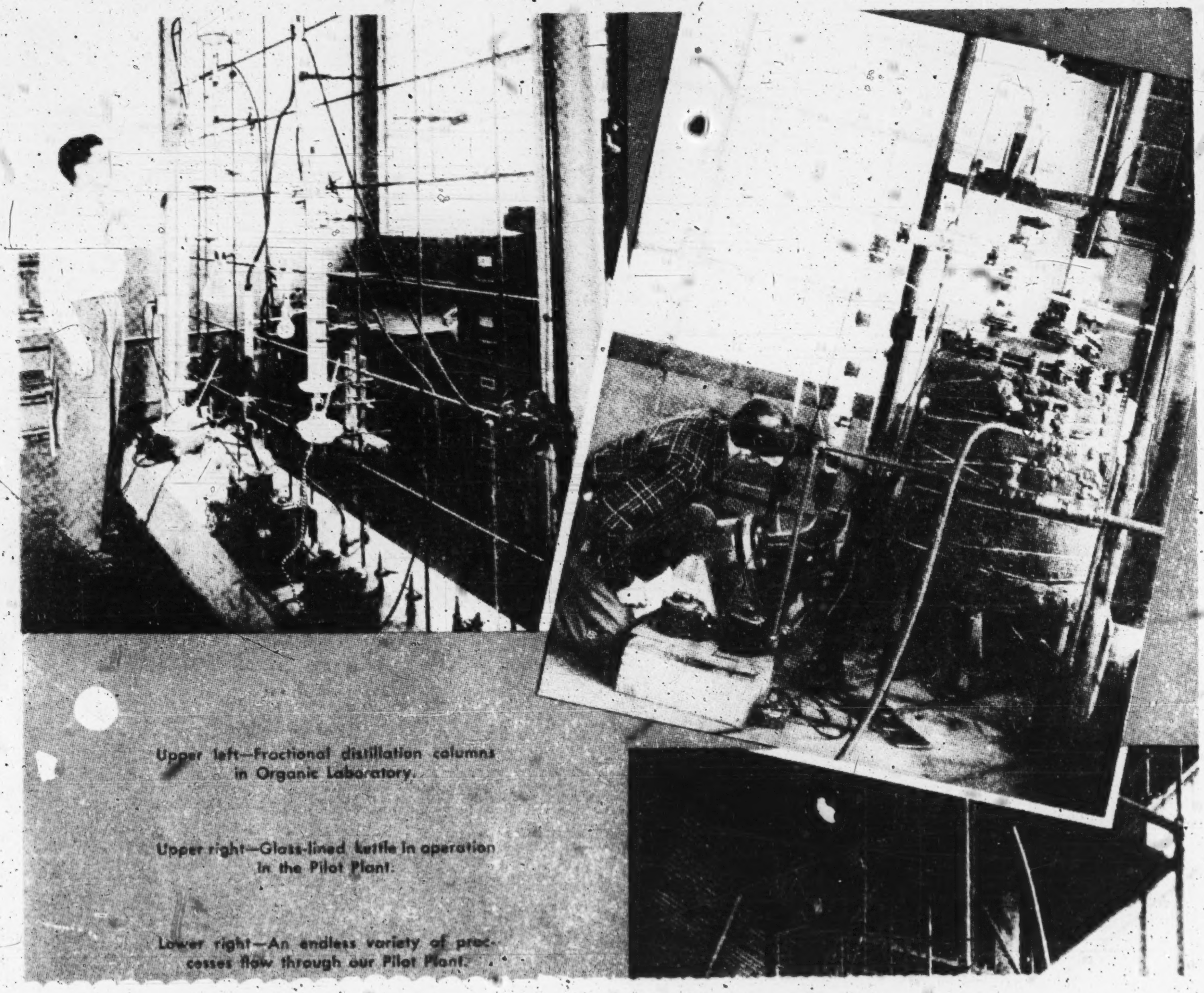
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In present day practice it is frequently necessary to follow a product into the field, study its uses, and render various services to the customer. The scope of the Technical Department includes technical field service, market development and analysis, and technical publications.

52-12

High-temperature muffle furnace in the Inorganic Research Laboratory





Upper left—Fractional distillation columns in Organic Laboratory.

Upper right—Glass-lined kettle in operation in the Pilot Plant.

Lower right—An endless variety of processes flow through our Pilot Plant.

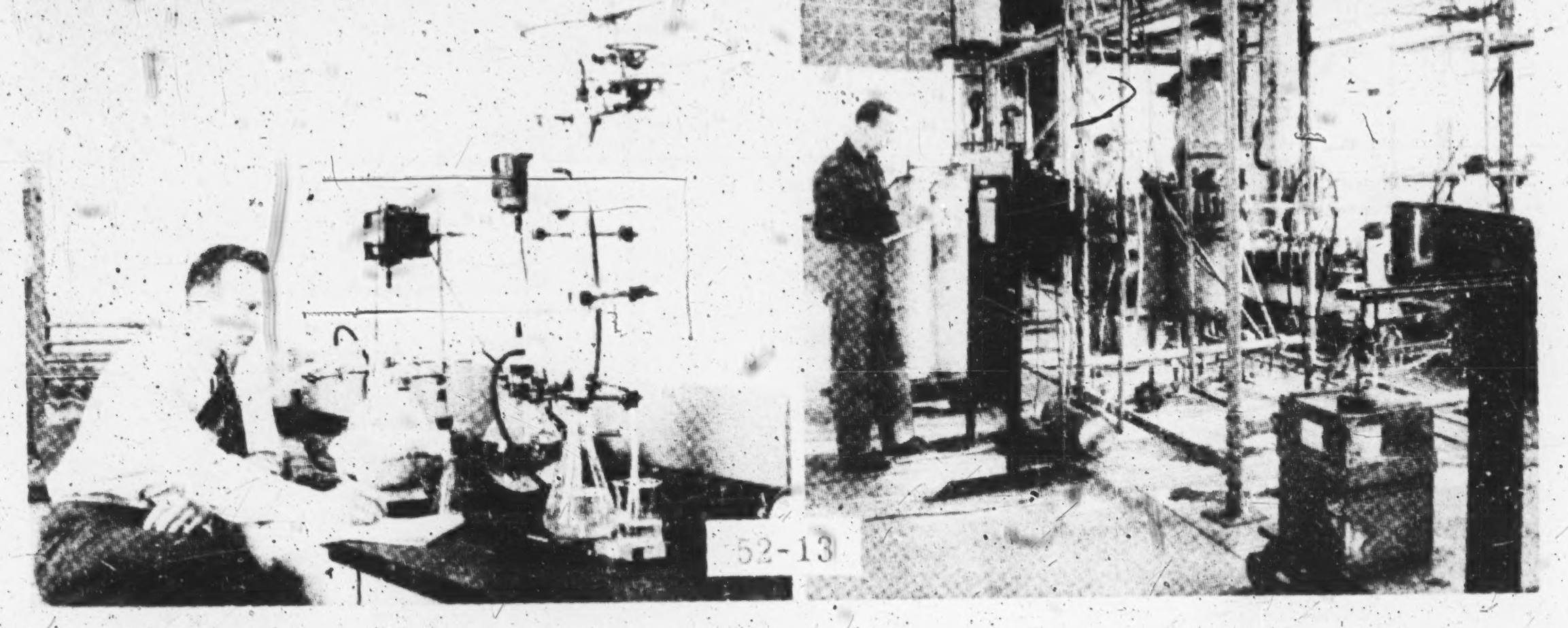
Upper left—Fractional distillation columns in Organic Laboratory.

Upper right—Glass-lined kettle in operation in the Pilot Plant.

Lower right—An endless variety of processes flow through our Pilot Plant.

Lower left—The beginning of a new Michigan Chemical product.

52-3



52-13

To the Stockholders

The year 1947 brought much greater recognition to Michigan Chemical Corporation. It was a year in which we scored our greatest growth in manufacturing facilities to date. Not only did we begin operations of our jointly owned affiliate, Pine Bluff Chemical Co., at Pine Bluff, Arkansas, but also substantially expanded our facilities at Saint Louis, Michigan. However, in spite of this substantial growth, our sales, which showed only a 7.2% increase for the year, were disappointing and consequent results were short of our goal.

Presented herewith are our financial reports as audited by Ernst & Ernst. The Profit and Loss statement will reveal a net loss for the year of $148,478. This compares with a profit of $137,802 for 1946. The charge for depreciation in 1947 amounted to $182,433 compared with the figure of $127,750 for depreciation of property, plant and equipment for the year 1946.

There were a number of factors affecting sales, not the least important of which was a decrease in DDT shipments to processors for compounding for the 1948 spring trade. Also generally, sales of DDT insecticides during the second half of 1947 were disappointing. The industry's production reached a new peak in July and this fact accompanied by a poor year for insecticides with consequent lack of demand caused price unsettlement and hesitancy on the part of buyers to make commitments. Nevertheless your management has confidence in the future of DDT insecticides and governmental authorities have forecast considerably greater use for these products in 1948.

During the year we added Pestmaster Rose Treatment to our household line and offered our 40% DDT Colloidal Dispersion (patents applied for) on an experimental basis. As this letter is being written officials of three important agricultural states have recommended the use of Colloidal Dispersion and your company is completing a new commercial plant to produce this material.

Near the close of the year we offered in local territories our new product, Winkie, a household detergent. Although we expect the expansion of our distribution of this product to be rather slow, we are nevertheless optimistic for the future of this excellent product.

From our Research came a number of new pharmaceuticals some of which are now being commercially produced and a plant to make chlorobromomethane, a new fire extinguishing material, is now nearing completion.

Inventories as of December 31, 1947 were $1,782,463, an increase of $1,019,096 over the December 31, 1946 figure. This substantial increase in inventories required borrowing of $400,000 as of December 31, 1947 and an additional $250,000 at this date. The latter amount is secured by our trade accounts receivable.

On July 11, 1947, 50,000 shares of common stock were sold for cash at $20 per share and bank loans then outstanding in the amount of $650,000 were retired. On June 15, 1947, $100,000 par value of our five year debentures were tendered for sinking fund requirements, these having been acquired for cash prior thereto. Also during the year $391,000 par value of debentures were tendered to the company at par in lieu of cash, for the purchase of common stock at the rate of $20.00 per share. This $391,000 par value of bonds was delivered to the Trustee to be applied against future sinking fund requirements, with the result that the sinking fund has been satisfied until June 15, 1950. These transactions reduced the par value of outstanding debentures from $850,000, as of January 1, 1947, to $359,000, as of January 1, 1948. Common stock now outstanding amounts to 297,077 shares and this figure also reflects the completion of options to employees to purchase 2,475 shares of common stock. There are no further options outstanding.

During the year we organized the Pine Bluff Chemical Co. to operate certain governmental leased facilities at Pine Bluff, Arkansas. Fifty percent of this corporation is owned by your company. Operations, with which Michigan Chemical Corporation are charged, have been on the whole satisfactory, subject of course to the usual problems encountered in the initial operating stages of a new plant. We are manufacturing Monochlorobenzene, Chloral, and DDT at Pine Bluff and anticpiate the addition of other products before the end of 1948.

The lease of this large plant, the purchase of additional equipment therefor, and working capital requirements were financed through the investment of $600,000, of which your corporation paid $150,000. The Michigan Chemical Corporation's interest is indicated on our balance sheet under the caption, "Investments and Other Assets." Our interest now represents an equity of $285,000, which increase is not reflected in the financial statements of your company. Our new organic plant is nearing completion and we expect to utilize it for the manufacture of several new products which our Research department has developed. Some of these hold considerable promise of becoming volume products during 1948.

The new pharmaceutical intermediate plant was placed in operation towards the end of 1947 and here too, we expect to add new products as soon as pilot plant operations are completed.

Our export operations were expanded during the year, in spite of the fact that many of our foreign customers encountered difficulty in obtaining U.S. dollars and import permits. However, we have several important contracts pending which may involve the location of plants in foreign countries, such plants to be financed with foreign capital. We will own a substantial interest in such enterprises as a consideration for supplying research, engineering, and "know how."

On December 31st, John L. Giles formerly Vice President and General Manager of your company resigned. Mr. Giles was one of the organizers of the company and contributed much toward its growth. It is with regret that we announce that his health no longer permits his association with the company.

The problems of a growing chemical company are legion. Although we continue to progress we are far short of our potential. We intend to continue our growth policy and as far as practical use every dollar available for this purpose. We believe such policies to be sound and trust that in the near future they will result in the realization of still greater progress.

H Davis

President

OFFICERS

T. C. DAVIS	President
R. A. BONDURANT, JR.	Vice President and Technical Director
A. M. BYERS	Vice President, Magnesium Oxide Sales
L. W. MUNCHMEYER	Vice President, Plant Operations
H. H. PROSKEY	Vice President, Consumer Sales
R. L. WILSON	Secretary
R. J. KNAPP	Treasurer
C. G. WOODS	Controller

DIRECTORS

T. C. DAVIS	GENE TUNNEY
C. N. JOHNS	C. WETHERALD
J. H. McMULLEN	W. F. WHEELER
C. S. MOTT	R. L. WILSON

Transfer Agent: National Bank of Detroit, Detroit, Michigan

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assets

BALANCE SHEET • DECEMBER 31, • 1947

CURRENT ASSETS		
Cash		$ 57,717.25
Trade accounts receivable	$ 410,187.99	
Less reserve	40,000.00	370,187.99
Refundable federal taxes on income		36,891.85
Inventories — at lower of cost (first-in, first-out method) or market:		
Finished product	$1,089,070.55	
Work in process	63,534.57	
Raw materials and containers	522,810.17	
Fuel and supplies	107,048.40	1,782,463.69
TOTAL CURRENT ASSETS		$2,247,260.78
INVESTMENTS AND OTHER ASSETS		
Capital stock of Pine Bluff Chemical Co. — at cost — Note A	$ 150,000.00	
Capital stock of Michigan Salt Company (100% owned) — at cost	1,000.00	
Cash surrender value of life insurance	8,950.00	
Equity in foreign enterprise	4,322.95	
Deposits, advances, and miscellaneous accounts	8,800.19	173,073.14
PROPERTY, PLANT, AND EQUIPMENT — at cost, less reserves for depreciation		
Land	$ 23,245.45	
Wells and reservoir	$ 140,582.47	
Buildings and other structures	472,780.11	
Machinery and equipment	875,623.01	
	$1,488,985.59	
Less reserves for depreciation	479,910.28	1,009,075.31
Construction in progress (estimated cost to complete — $130,000.00)	82,189.38	1,114,510.14
DEFERRED CHARGES		
Unexpired insurance premiums		27,373.38
		$3,562,217.44

liabilities

BALANCE SHEET • DECEMBER 31, • 1947

CURRENT LIABILITIES		
Notes payable to bank		$ 400,000.00
Accounts payable and accrued expenses:		
Trade accounts	$ 269,068.27	
To Pine Bluff Chemical Co. (an affiliated company — See Note A)	38,650.02	
Salaries, wages, and commissions	30,748.24	
Pay roll taxes, and income taxes withheld from employees	24,092.33	
Taxes, interest, and miscellaneous accruals	33,317.50	395,876.36
TOTAL CURRENT LIABILITIES		$ 795,876.36
LONG-TERM DEBT — Note B		
Five-year 4% Convertible Debentures due June 15, 1951		359,000.00
CAPITAL STOCK AND SURPLUS — Note B		
Common stock, par value $1.00 per share:		
Authorized 1,000,000 shares		
Unissued (of which 10,165 shares are reserved for conversion of debentures) 702,923 shares		
Issued and outstanding 297,077 shares	$ 297,077.00	
Capital surplus	2,106,073.45	
Earned surplus	4,190.63	2,407,341.08
		$3,562,217.44

CONTINGENT LIABILITIES

As guarantor of payments (including annual rent of $60,000.00) and performance of obligations incumbent upon Pine Bluff Chemical Co. under a lease of certain government-owned properties and under a contract for the purchase of raw materials. The other participating company (see Note A) has agreed to reimburse Michigan Chemical Corporation for 50% of any losses it may sustain under the guarantee agreements.

See notes on second page following.

profit and loss summary

YEAR ENDED DECEMBER 31, 1947

Sales, less cost of products sold		$765,036.27
Expenses:		
Selling and advertising	$677,282.50	
Administrative and general (including provision of $15,000.00 for doubtful accounts)	219,607.74	896,890.24
		$131,853.97*
Other income		2,911.90
		$128,942.07*
Other deductions:		
Interest expense (including $24,617.77 on 4% debentures)	$ 32,464.58	
Loss on disposal of equipment	6,421.60	
Charge in connection with allotment to employees of rights to purchase 2,475 shares of Common Stock at $5.00 a share	34,650.00	73,536.18
LOSS BEFORE INCOME TAX CREDITS		$202,478.25*
Refundable taxes on income of the year 1946 arising from carry-back of operating loss — estimated		54,000.00
NET LOSS		$148,478.25*

*Indicates red figure.

Provision for depreciation of property, plant, and equipment for the year amounted to $182,433.49.

[redacted]

Charge in connection with allotment to employees of rights to purchase 2,475 shares of Common Stock at $5.00 a share	34,650.00	73;536.18
LOSS BEFORE INCOME TAX CREDITS		$202,478.25*
Refundable taxes on income of the year 1946 arising from carry-back of operating loss — estimated		54,000.00
NET LOSS		$148,478.25*

*Indicates red figure.

Provision for depreciation of property, plant, and equipment for the year amounted to $182,433.49.

statement of surplus

YEAR ENDED DECEMBER 31, 1947

CAPITAL SURPLUS		
Balance at January 1, 1947		$ 727,313.45
Additions:		
Excess of estimated fair value at allotment date over option price ($5.00 a share) of 2,475 shares of Common Stock as to which rights to purchase were allotted to employees during the year		34,650.00
Excess of selling price over par value of Common Stock sold during the year:		
50,000 shares sold for cash at $20.00	$ 950,000.00	
19,550 shares issued at $20.00 in consideration for surrender of $391,000.00 principal amount of Five-year 4% Convertible Debentures	371,450.00	
5,665 shares sold at $5.00 to employees under stock options	22,660.00	1,344,110.00
Balance at December 31, 1947		$2,106,073.45
EARNED SURPLUS		
Balance at January 1, 1947		$ 152,668.88
Net loss for the year		148,478.25
Balance at December 31, 1947		$ 4,190.63

Notes to Balance Sheet

Note A — At December 31, 1947, all the outstanding capital stock of Pine Bluff Chemical Co. was owned by Michigan Chemical Corporation. Since that date Pine Bluff Chemical Co. has sold an equal number of shares to another company, reducing Michigan Chemical Corporation's ownership to 50%, representing an equity of approximately $285,000.00 in net assets of Pine Bluff Chemical Co.

Note B — The Corporation is required to retire Five-year Convertible Debentures through the operation of a sinking fund. Debentures retired during the year 1947 have been sufficient to meet the sinking fund requirements until June 15, 1950. Debentures outstanding at December 31, 1947, may be converted into Common Stock at the option of the debenture holders at the rate of one share for each $35.32 of principal amount.
The Corporation has agreed that it will pay no dividends on the Common Stock so long as any debentures are outstanding.

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The Corporation has agreed that it will pay no dividends an the Common Stock so long as any debentures are outstanding.

ACCOUNTANTS' REPORT

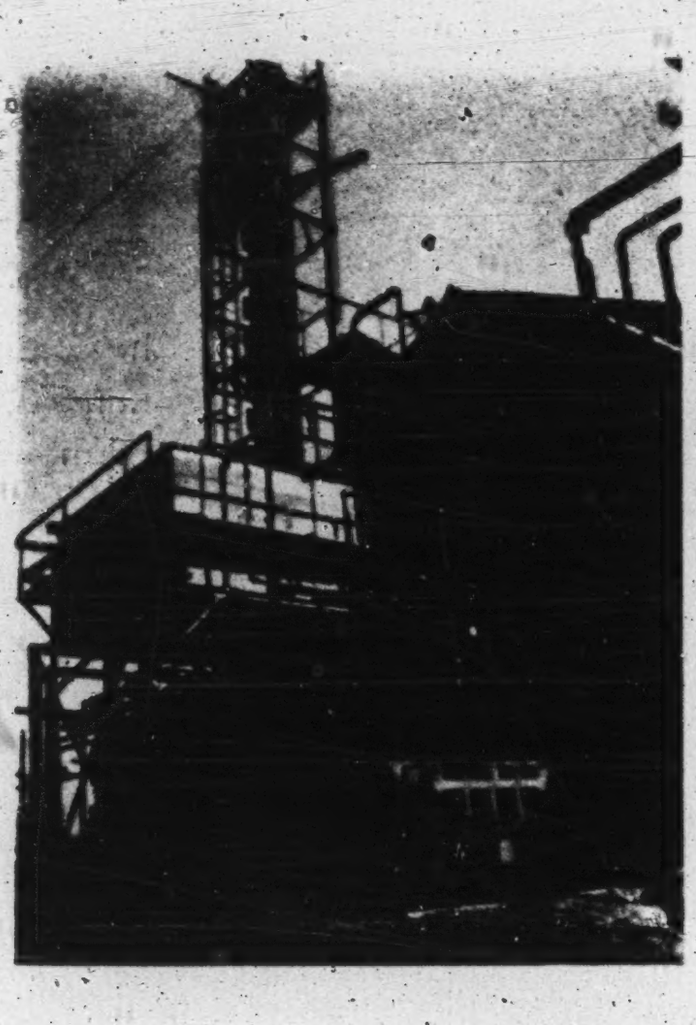
Board of Directors,
Michigan Chemical Corporation,
Saint Louis, Michigan.

We have examined the balance sheet of Michigan Chemical Corporation as of December 31, 1947, and the statements of profit and loss and surplus for the year then ended, have reviewed the system of internal control and the accounting procedures of the Corporation and, without making a detailed audit of the transactions, have examined or tested accounting records of the Corporation and other supporting evidence, by methods and to the extent we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary.

In our opinion, the accompanying balance sheet and related summary of profit and loss and statement of surplus present fairly the position of Michigdn Chemical Corporation at December 31, 1947, and the results of its operations for the year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

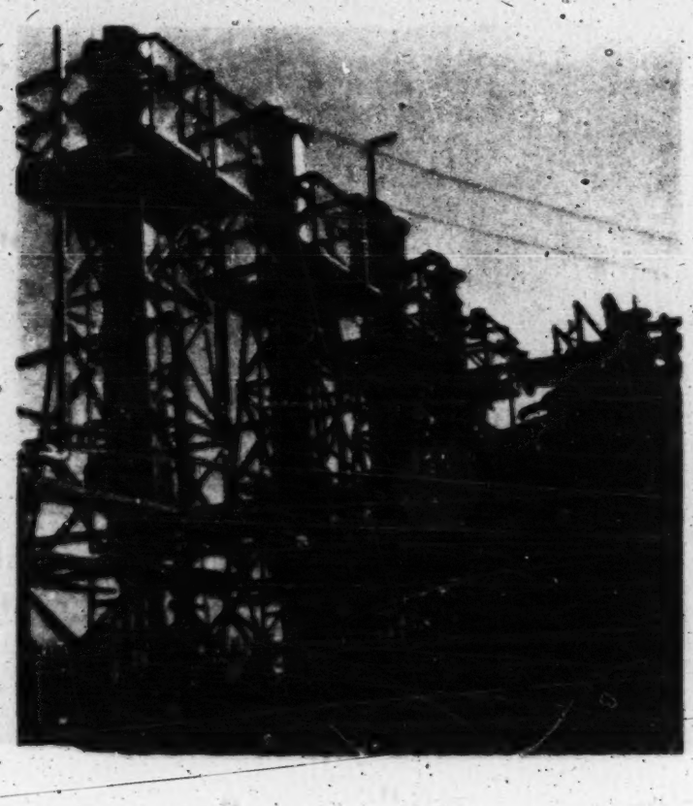
February 17, 1948
Grand Rapids, Michigan

ERNST & ERNST
Certified Public Accountants



PINE BLUFF CHEMICAL CO.

On February 6, 1947, Pine Bluff Chemical Co., a jointly-owned subsidiary of Michigan Chemical Corporation was organized to operate a plant at Pine Bluff, Arkansas, manufacturing industrial and insecticidal chemicals. Part of the facilities of the former Pine Bluff Arsenal were leased and the manufacture of monochlorobenzene and DDT began May 1st. During the summer, capacity of the plant was increased.



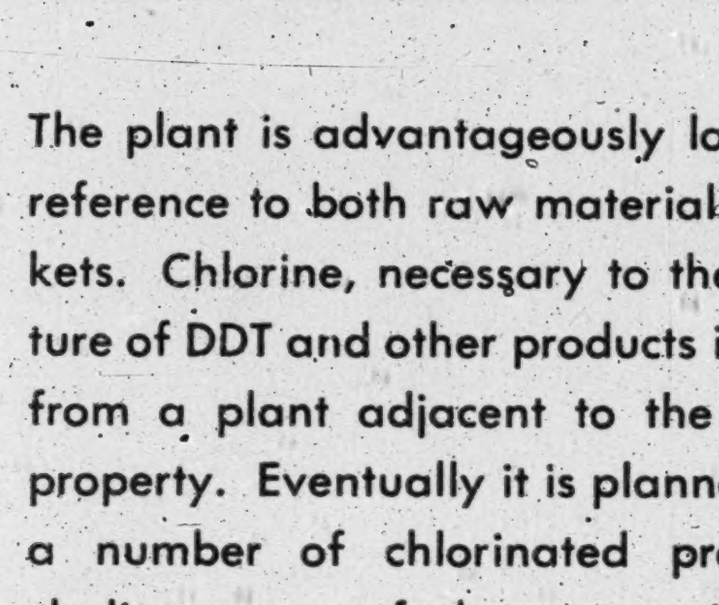
The plant is advantageously located with reference to both raw materials and markets. Chlorine, necessary to the manufacture of DDT and other products is available from a plant adjacent to the Pine Bluff property. Eventually it is planned to make

capacity of the plant was increased.





The plant is advantageously located with reference to both raw materials and markets. Chlorine, necessary to the manufacture of DDT and other products is available from a plant adjacent to the Pine Bluff property. Eventually it is planned to make a number of chlorinated products, including some of the newer insecticides.



Officers of Pine Bluff Chemical Co. are T. C. Davis, president; L. W. Munchmeyer, vice-president; and Clarence G. Woods, secretary-treasurer. Operation of the plant is under direct supervision of the Michigan Chemical Corporation.

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Michigan Chemical Corporation

Plant and Main Office • Saint Louis, Michigan

EASTERN SALES OFFICE	230 Park Avenue, New York, N. Y.
MIDWESTERN SALES OFFICE	510 Insurance Exchange Building, Kansas City, Missouri
EXPORT DIVISION	Saint Louis, Michigan Cable Address "Michemco"

52-22

PRINTED IN U.S.A.

Exhibit N

File this return with Collector of Internal Revenue on or before March 15, 1947. Any balance of tax due (item 9, below) must be paid in full with return. See separate instructions for filling out return.

Page 1

FORM 1040
Treasury Department
Internal Revenue Service

U. S. INDIVIDUAL INCOME TAX RETURN
FOR CALENDAR YEAR 1946

FILED 1946

or fiscal year beginning ..... 1946, and ending 1947

EMPLOYEES.—Instead of this form, you may use your Withholding Statement, Form W-2, as your return, if your total income was less than $5,000, consisting wholly of wages shown on Withholding Statements or of such wages and not more than $100 of other wages, dividends, and interest.

Do not write in these spaces
File Code 878
Serial No. 3085479
District
(Cashier's Stamp)

THE TAX COURT OF THE U.S.
DIV ... DOCKET
OCT 14 1953
PET ... NUMBER
RESPONDENT

Name Philip J. LoBue
(PLEASE PRINT. If this return is for a husband and wife, use both first names)

ADDRESS 106 Leonia Avenue
(PLEASE PRINT. Street and number or rural route)

Leonia, Bergen, New Jersey
(City or town, postal zone number) (County) (State)

Occupation Chemist Social Security No.

B

Your Exemptions

List your own name. If married and your wife (or husband) had no income, or if this is a joint return of husband and wife, list name of your wife (or husband).

List names of other close relatives (as defined in instruction 1) with 1946 incomes of less than $500 who received more than one-half of their support from you. If this is a joint return of husband and wife, list dependent relatives of both.

1. Name (please print)	Relationship	Name (please print)	Relationship
Your name Philip J.	xxxxxxxxx		
Edna	wife		
Bonnie Ann	daughter		
Philip James	son		

Your Income

Enter your total wages, salaries, bonuses, commissions, and other compensation received in 1946, BEFORE PAY-ROLL DEDUCTIONS for taxes, dues, insurance, bonds, etc. Members of armed forces and persons claiming traveling or reimbursed expenses, see instruction 2.

2. Print Employer's Name	Where Employed (City and State)	Amount	
Michigan Chemical Products Corp.	New York City office	$ 6,600 00	
		Enter total here →	$ 6,600 00

3. Enter here the total amount of your dividends .....
4. Enter here the total amount of your interest (including interest from Government obligations unless wholly exempt from taxation) 3,802 06
5. If you received any other income, give details on page 2 and enter the total here 3,802 06

Exemptions

Name		
Philip J.	xxxxxxxxx	
Edna	wife	
Bonnie Ann	daughter	
Philip James	son	

Your Income

Enter your total wages, salaries, bonuses, commissions, and other compensation received in 1946, BEFORE PAY-ROLL DEDUCTIONS for taxes, dues, insurance, bonds, etc. Members of armed forces and persons claiming traveling or reimbursed expenses, see instruction 2.

2. Print Employer's Name	Where Employed (City and State)	Amount	
Michigan Chemical Products Corp.	New York City office	$ 6,600 00	
		Enter total here →	$ 6,600 00

3. Enter here the total amount of your dividends .....
4. Enter here the total amount of your interest (including interest from Government obligations unless wholly exempt from taxation) .....
5. If you received any other income, give details on page 2 and enter the total here 3,802 06
6. Add amounts in items 2, 3, 4, and 5, and enter the total here ..... $ 10,402 06

How to Figure Your Tax

IF YOUR INCOME WAS LESS THAN $5,000.—You may find your tax in the tax table on page 4. This table, which is provided by law, automatically allows about 10 percent of your total income for charitable contributions, interest, taxes, casualty losses, medical expenses, and miscellaneous expenses. If your expenditures and losses of these classes amount to more than 10 percent, it will usually be to your advantage to itemize them and compute your tax on page 3.

IF YOUR INCOME WAS $5,000 OR MORE.—Disregard the tax table and compute your tax on page 3. You may either take a standard deduction of $500 or itemize your deductions, whichever is to your advantage.

HUSBAND AND WIFE.—If husband and wife file separate returns, and one itemizes deductions, the other must also itemize deductions.

Tax Due or Refund

7. Enter your tax from table on page 4, or from line 12, page 3		$ 1,644 37
8. How much have you paid on your 1946 income tax? (A) By withholding from your wages	$ 784 80	
(B) By payments on 1946 Declaration of Estimated Tax	971 20	
Enter total here →		1,756 00
9. If your tax (item 7) is larger than payments (item 8), enter BALANCE OF TAX DUE here		$
10. If your payments (item 8) are larger than your tax (item 7), enter the OVERPAYMENT here		$ 111 63

Check (✓) whether you want this overpayment: Refunded to you ☐; or Credited on your 1947 estimated tax ☒

If you filed a return for a prior year, what was the latest year? 1945
To which Collector's office was it sent? Newark, N.J.
To which Collector's office did you pay amount claimed in item 8 (B), above? Newark, N.J.

Is your wife (or husband) making a separate return for 1946? no ("Yes" or "No")
If "Yes," write below:
Name of wife (or husband)
Collector's office to which sent

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

Ernest H. Baldwin
(Signature of person (other than taxpayer or agent) preparing return) (Date)

(Signature of taxpayer) (Date)

(Name of firm or employer, if any)

(If this is a joint return of husband and wife, it must be signed by both)

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Your Exemptions

1. Name (please print)	Relationship	Name (please print)	Relationship
Your name Philip J. LoBue	xxxxxxxxx		
Edna	Wife		
Bonnie Ann	Daughter		
Philip James	Son		

Your Income

Enter your total wages, salaries, bonuses, commissions, and other compensation received in 1947, BEFORE PAY-ROLL DEDUCTIONS for taxes, dues, insurance, bonds, etc. Members of armed forces and persons claiming traveling or reimbursed expenses, see instruction 2.

2. Print Employer's Name	Where Employed (City and State)	Amount	
Michigan Chemical Products Corp.	N. Y. C.	$ 500 00	
		Enter total here →	$ 500 00

3. Enter here the total amount of your dividends .....
4. Enter here the total amount of your interest (including interest from Government obligations unless wholly exempt from taxation) 13,368 53
5. If you received any other income, give details on page 2 and enter the total here 13,868 53
6. Add amounts in items 2, 3, 4, and 5, and enter the total here ..... $ 13,868 53

How to Figure Your Tax

IF YOUR INCOME WAS LESS THAN $5,000.—You may find your tax in the tax table on page 4. This table, which is provided by law, automatically allows about 10 percent of your total income for charitable contributions, interest, taxes, casualty losses, medical expenses, and miscellaneous expenses. If your expenditures and losses of these classes amount to more than 10 percent, it will usually be to your advantage to itemize them and compute your tax on page 3.

IF YOUR INCOME WAS $5,000 OR MORE.—Disregard the tax table and compute your tax on page 3. You may either take a standard deduction of $500 or itemize your deductions, whichever is to your advantage.

HUSBAND AND WIFE.—If husband and wife file separate returns, and one itemizes deductions, the other must also itemize deductions.

Tax Due or Refund

7. Enter your tax from table on page 4, or from line 12, page 3		$ 2,783 29
8. How much have you paid on your 1947 income tax? (A) By withholding from your wages	$ 65 40	
(B) By payments on 1947 Declaration of Estimated Tax	2,100 00	
Enter total here →		2,165 40
9. If your tax (item 7) is larger than payments (item 8), enter BALANCE OF TAX DUE here		$ 617 89
10. If your payments (item 8) are larger than your tax (item 7), enter the OVERPAYMENT here		$

Check (✓) whether you want this overpayment: Refunded to you ☐; or Credited on your 1948 estimated tax ☐

If you filed a return for a prior year, what was the latest year? 1946
To which Collector's office was it sent? Newark, N.J.
To which Collector's office did you pay amount claimed in item 8 (B), above? Same

Is your wife (or husband) making a separate return for 1947? NO ("Yes" or "No")
If "Yes," write below:
Name of wife (or husband)
Collector's office to which sent

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

Irving M. Cole MAR 4 1948
(Signature of person (other than taxpayer or agent) preparing return) (Date)

Philip J. LoBue MAR 4 1948
(Signature of taxpayer) (Date)

(Name of firm or employer, if any)

(If this is a joint return of husband and wife, it must be signed by both)

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Do not use this page if your income is wholly from salaries, wages, dividends, and interest

Schedule A.—INCOME FROM ANNUITIES OR PENSIONS

1. Cost of annuity (total amount you paid in)	$	4. Total amount received this year	$
2. Amount received tax-free in prior years		5. Excess, if any, of line 4 over line 3	
3. Remainder of your cost (line 1 less line 2)	$	6. Enter line 5, or 3 percent of line 1, whichever is greater (Attach separate schedule for each additional annuity or pension)	$

Schedule B.—INCOME FROM RENTS AND ROYALTIES

1. Kind of property	2. Amount of rent or royalty	3. Depreciation or depletion (explain in Schedule F)	4. Repairs (explain in Schedule G)	5. Other expenses (itemize in Schedule G)
	$	$	$	$
Net profit (or loss) (col. 2 less sum of cols. 3, 4, and 5)	$	$	$	$

Schedule C.—PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION. (Farmers should obtain Form 1040F)

(State (1) nature of business Dealer in chemicals; (2) business name D & L Chem. Prod. Co.

1. Total receipts			$ 61,150.21
COST OF GOODS SOLD (To be used where inventories are an income-determining factor) (Enter the letters "C" or "C or M" on lines 2 and 8 if inventories are valued at either cost, or cost or market, whichever is lower)		**OTHER BUSINESS DEDUCTIONS**	
2. Inventory at beginning of year	$	11. Salaries and wages not in line 4	$
3. Merchandise bought for sale	50,840.15	12. Interest on business indebtedness	
4. Labor		13. Taxes on business and business property	
5. Material and supplies		14. Losses (explain in Schedule G)	
6. Other costs Commissions (explain in Schedule G)	5,181.65	15. Bad debts arising from sales or services	
7. Total of lines 2 to 6	$ 56,021.80	16. Depreciation, obsolescence and depletion (explain in Schedule F)	
8. Less inventory at end of year	7	17. Rent, repairs, and other expenses (explain in Schedule G)	1,326.35
9. Net cost of goods sold (line 7 less line 8)	$ 56,021.80	18. Amortization of emergency facilities (attach statement)	
		19. Net operating loss deduction (attach statement)	
		20. Total of lines 11 to 19	$ 1,326.35
		21. Total of lines 9 and 20	$ 57,348.15
10. Gross profit (line 1 less line 9)	$ 5,128.41	22. Net profit (or loss) (line 1 less line 21)	3,802.06

Schedule D.—GAINS AND LOSSES FROM SALES OR EXCHANGES OF CAPITAL ASSETS, ETC.

1. Net gain (or loss) from sale or exchange of capital assets (from separate Schedule D)	
2. Net gain (or loss) from sale or exchange of property other than capital assets (from separate Schedule D)	

Schedule E.—INCOME FROM PARTNERSHIPS, ESTATES AND TRUSTS, AND OTHER SOURCES

1. Name and address of partnership, syndicate, etc.	Amount,	$
2. Name and address of estate or trust	Amount,	
3. Other sources (state nature)	Amount,	
4. Total		
Total income from above sources (Enter as item 5, page 1)		$ 3,802.06

Schedule F.—EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED IN SCHEDULES B AND C

1. Kind of property (If buildings, state material of which constructed)	2. Date acquired	3. Cost or other basis (do not include land or other nondepreciable property)	4. Assets fully depreciated in use at end of year	5. Depreciation allowed (or allowable) in prior years	6. Remaining cost or other basis to be recovered	7. Estimated life used in accumulating depreciation	8. Estimated remaining life from beginning of year	9. Depreciation allowable this year
		$	$	$	$			$

Schedule G.—EXPLANATION OF COLUMNS 4 AND 5 OF SCHEDULE B, AND LINES 6, 14, AND 17 OF SCHEDULE C

1. Column or Line No.	2. Explanation	3. Amount	1. Column or Line No.	2. Explanation	3. Amount
17	Office Exp. & Sply	$ 97.54	17	Legal expenses	$ 31.00
	Office Service	205.00		Total Item 17	1,326.35
	Expressage	17.10			
	Selling & entert.Exp.	955.88			
	Suhdry expenses	19.83			

16—40284-1 ☆ GPO

Do not itemize deductions if—(1) You determine your tax from the tax table on page 4, or
(2) Your total income is $5,000 or more and you claim the $500 standard deduction.
If husband and wife living together at end of year file separate returns and one itemizes deductions, the other must file his or her return on Form 1040, and must also itemize deductions.

DEDUCTIONS

Describe deductions and state to whom paid. If more space is needed, list deductions on separate sheet of paper and attach to this return.		Amount
Contributions	Church	$ 100.00	
	Community Chest, Red Cross,		
	Tuberculosis League, Fresh Air Fd.	65.00	
	Allowable Contributions (not in excess of 15 percent of item 6, page 1)		$ 165.00
Interest	Interest on Mortgage, residence	$ 277.99	
	Interest on Life Insur. Loan	60.00	
	Total Interest		337.99
Taxes	on Residence	$ 260.58	
	New York Sales Taxes	24.00	
	Auto License, Gasoline Tax	44.00	
	Total Taxes		328.58
Losses from fire, storm, shipwreck, or other casualty, or theft.		$	
	Total Allowable Losses (not compensated by insurance or otherwise)		
Medical and dental expenses		$	
	Net Expenses (not compensated by insurance or otherwise)	$	
	Enter 5 percent of item 6, page 1, and subtract from Net Expenses		
	Allowable Medical and Dental Expenses. See Instruction for limitation		
Miscellaneous	Entert. of customers at home	$ 150.00	
	Auto Repairs & Ins. f.business	184.09	

	Total Taxes		328.58
Losses from fire, storm, shipwreck, or other casualty, or theft.		$	
	Total Allowable Losses (not compensated by insurance or otherwise)		
Medical and dental expenses		$	
	Net Expenses (not compensated by insurance or otherwise)	$	
	Enter 5 percent of item 6, page 1, and subtract from Net Expenses		
	Allowable Medical and Dental Expenses. See Instruction for limitation		
Miscellaneous (See Instructions)	Entert. of customers at home	$ 150.00	
	Auto Repairs & Ins. f.business	184.09	

Total Miscellaneous Deductions		334.09
TOTAL DEDUCTIONS		$ 1,165.66 ✓

TAX COMPUTATION—FOR PERSONS NOT USING TAX TABLE ON PAGE 4

1. Enter amount shown in item 6, page 1. This is your Adjusted Gross Income	$10,402.06 ✓
2. Enter DEDUCTIONS (if deductions are itemized above, enter the total of such deductions; if adjusted gross income (line 1, above) is $5,000 or more and deductions are not itemized, enter the standard deduction of $500)	1,165.66 ✓
3. Subtract line 2 from line 1. Enter the difference here. This is your Net Income	$ 9,236.40
4. Enter your exemptions ($500 for each person whose name is listed in item 1, page 1)	2,000.00 ✓
5. Subtract line 4 from line 3. Enter the difference here	$ 7,236.40 ✓
6. Use the tax rates in instruction sheet to figure your combined tentative normal tax and surtax on amount entered on line 5. Enter the tentative tax here. (If line 3 above includes partially tax-exempt interest, see Tax Computation Instructions)	$ 1,730.92
7. Enter here 5 percent of amount entered on line 6	86.55
8. Subtract line 7 from line 6. Enter the difference here. This is your combined normal tax and surtax. (If alternative tax computation is made on separate Schedule D, enter here tax from line 12 of Schedule D)	$ 1,644.37 ✓

IF YOU USED THE $500 STANDARD DEDUCTION IN LINE 2, DISREGARD LINES 9, 10, AND 11, AND COPY ON LINE 12 THE SAME FIGURE YOU ENTERED ON LINE 8.

9. Enter here any income tax payments to a foreign country or U. S. possession (attach Form 1116)	$	
10. Enter here any income tax paid at source on tax-free covenant bond interest		
11. Add the figures on lines 9 and 10 and enter the total here		
12. Subtract line 11 from line 8. Enter the difference here and in item 7, page 1. This is your tax		$ 1,644.37

10—62264-1

A-7

		66	0	0	0			356	261	166	71	0	0	0	0	0
		70	0	0	0			360	265	170	75	0	0	0	0	0
		74	0	0	0	2,675	2,700	365	270	175	80	0	0	0	0	0
		78	0	0	0	2,700	2,725	369	274	179	84	0	0	0	0	0
		82	0	0	0	2,725	2,750	373	278	183	88	0	0	0	0	0
		87	0	0	0	2,750	2,775	377	282	187	92	0	0	0	0	0
		91	0	0	0	2,775	2,800	382	287	192	97	2	0	0	0	0
		95	0	0	0	2,800	2,825	387	291	196	101	6	0	0	0	0
		100	5	0	0	2,825	2,850	391	295	200	105	10	0	0	0	0
		104	9	0	0	2,850	2,875	396	299	204	109	14	0	0	0	0
		108	13	0	0	2,875	2,900	401	304	209	114	19	0	0	0	0
		112	17	0	0	2,900	2,925	405	308	213	118	23	0	0	0	0
		117	22	0	0	2,925	2,950	410	312	217	122	27	0	0	0	0
		121	26	0	0	2,950	2,975	415	317	222	127	32	0	0	0	0
2,975	3,000	125	30	0	0	2,975	3,000	419	321	226	131	36	0	0	0	0
		129	34	0	0	3,000	3,050	427	327	232	137	42	0	0	0	0
3,050	3,100	134	39	0	0	3,050	3,100	436	336	241	146	51	0	0	0	0
3,100	3,150	138	43	0	0	3,100	3,150	445	344	249	154	59	0	0	0	0
3,150	3,200	142	47	0	0	3,150	3,200	455	353	258	163	68	0	0	0	0
3,200	3,250	147	52	0	0	3,200	3,250	464	361	266	171	76	0	0	0	0
3,250	3,300	151	56	0	0	3,250	3,300	474	370	275	180	85	0	0	0	0
3,300	3,350	155	60	0	0	3,300	3,350	483	379	284	189	94	0	0	0	0
3,350	3,400	159	64	0	0	3,350	3,400	492	388	292	197	102	7	0	0	0
3,400	3,450	164	69	0	0	3,400	3,450	502	397	301	206	111	16	0	0	0
3,450	3,500	168	73	0	0	3,450	3,500	511	407	309	214	119	24	0	0	0
3,500	3,550	172	77	0	0	3,500	3,550	521	416	318	223	128	33	0	0	0
3,550	3,600	176	81	0	0	3,550	3,600	530	425	326	231	136	41	0	0	0
3,600	3,650	181	86	0	0	3,600	3,650	539	435	335	240	145	50	0	0	0
3,650	3,700	185	90	0	0	3,650	3,700	549	444	343	248	153	58	0	0	0
3,700	3,750	189	94	0	0	3,700	3,750	558	454	352	257	162	67	0	0	0
3,750	3,800	194	99	4	0	3,750	3,800	568	463	361	266	171	76	0	0	0
3,800	3,850	198	103	8	0	3,800	3,850	577	472	369	274	179	84	0	0	0
3,850	3,900	202	107	12	0	3,850	3,900	586	482	378	283	188	93	0	0	0
3,900	3,950	206	111	16	0	3,900	3,950	596	491	387	291	196	101	6	0	0
3,950	4,000	211	116	21	0	3,950	4,000	605	501	396	300	205	110	15	0	0
4,000	4,050	215	120	25	0	4,000	4,050	615	510	406	308	213	118	23	0	0
4,050	4,100	219	124	29	0	4,050	4,100	624	520	415	317	222	127	32	0	0
4,100	4,150	223	128	33	0	4,100	4,150	633	529	424	325	230	135	40	0	0
4,150	4,200	228	133	38	0	4,150	4,200	643	538	434	334	239	144	49	0	0
4,200	4,250	232	137	42	0	4,200	4,250	652	548	443	342	247	152	57	0	0
4,250	4,300	236	141	46	0	4,250	4,300	662	557	453	351	256	161	66	0	0
4,300	4,350	241	146	51	0	4,300	4,350	671	567	462	360	265	170	75	0	0
4,350	4,400	245	150	55	0	4,350	4,400	680	576	471	368	273	178	83	0	0
4,400	4,450	249	154	59	0	4,400	4,450	690	585	481	377	282	187	92	0	0
4,450	4,500	253	158	63	0	4,450	4,500	699	595	490	386	290	195	100	5	0
4,500	4,550	258	163	68	0	4,500	4,550	709	604	500	395	299	204	109	14	0
4,550	4,600	262	167	72	0	4,550	4,600	718	614	508	405	307	212	117	22	0
4,600	4,650	266	171	76	0	4,600	4,650	727	623	518	414	316	221	126	31	0
4,650	4,700	271	176	81	0	4,650	4,700	737	632	528	423	324	229	134	39	0
4,700	4,750	275	180	85	0	4,700	4,750	746	642	537	433	333	238	143	48	0
4,750	4,800	279	184	89	0	4,750	4,800	756	651	547	442	342	247	152	57	0
4,800		283	188	93	0	4,800	4,850	765	661	556	452	350	255	160	65	0
						4,850	4,900	774	670	565	461	359	264	169	74	0
						4,900	4,950	784	679	575	470	367	272	177	82	0
						4,950	5,000	793	689	584	480	376	281	186	91	0

☆ U. S. GOVERNMENT PRINTING OFFICE 16—49354-1

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Exhibit O

File this return with Collector of Internal Revenue on or before March 15, 1948. Any balance of tax due (item 9, below) must be paid in this return. See separate instructions for filing out return.

Page 1

FORM 1040
Treasury Department
Internal Revenue Service

U. S. INDIVIDUAL INCOME TAX RETURN
FOR CALENDAR YEAR 1947

1947

or fiscal year beginning ....., 1947, and ending ....., 1948

EMPLOYEES.—Instead of this form, you may use your Withholding Statement Form W-2, as your return, if your total income was less than $5,000, consisting wholly of wages shown on Withholding Statements or of such wages and not more than $100 of other wages, dividends, and interest.

Do not write in these spaces
File Code
Serial No. 3226541
District
(Cashier's Stamp)

TAX COURT

OCT 14 1953

EXHIBIT
RESPONDENT'S

THE TAX COURT OF THE U.S.
DIV. — DOCKET 57
ADMITTED IN EVIDENCE
OCT 14 1953
PETITIONER'S
EXHIBIT O

Name Philip J. LoBue
(PLEASE PRINT. If this return is for a husband and wife, use both first names)

ADDRESS 106 Leonia Avenue
(PLEASE PRINT. Street and number or rural route)

Leonia (City or town, postal zone number) Bergen (County) New Jersey (State)

Occupation Chemist Social Security No.

Your Exemptions

List your own name. If married and your wife (or husband) had no income, or if this is a joint return of husband and wife, list name of your wife (or husband).

List names of other close relatives (see instruction 1) with 1947 incomes of less than $500 who received over half of their support from you. If this is a joint return of husband and wife, list dependent relatives of both.

	Name (please print)	Relationship	Name (please print)	Relationship
1. Your name	Philip J. LoBue	xxxxxxxxx		
	Edna W	Wife		
	Bonnie Ann	Daughter		
	Philip James	Son		

Your Income

Enter your total wages, salaries, bonuses, commissions, and other compensation received in 1947, BEFORE PAY-ROLL DEDUCTIONS for taxes, dues, insurance, bonds, etc. Members of armed forces and persons claiming traveling or reimbursed expenses, see Instruction 2.

2. Print Employer's Name	Where Employed (City and State)	Amount	
Michigan Chemical Products Corp.	N. Y. C.	$ 500 00	
		Enter total here →	$ 500 00

3. Enter here the total amount of your dividends .....

4. Enter here the total amount of your interest (including interest from Government obligations unless wholly exempt from taxation) 13.368 53

If you use this table, tear off this page and file only pages 1 and 2

TAX TABLE

FOR PERSONS WITH INCOMES UNDER $5,000 NOT COMPUTING TAX ON PAGE 3

Read down the shaded columns below until you find the line covering the total income you entered in item 8, page 1. Then read across to the column headed by the number corresponding to the number of persons listed in item 1, page 1. Enter the tax you find there in item 7, page 1.

If total income in item 8, page 1, is—		And the number of persons listed in item 1, page 1, is—										
At least	But less than	1	2	3	4	5	6	7	8	9	10	11
		The tax is—										
$0	$2,250	$0	$0	$0	$0	$288	$193	$98	$3	$0	$0	$0	$0	$0
2,250	2,275	1	0	0	0	292	197	102	7	0	0	0	0	0
2,275	2,300	5	0	0	0	296	201	106	11	0	0	0	0	0
2,300	2,325	10	0	0	0	300	205	110	15	0	0	0	0	0
2,325	2,350	14	0	0	0	305	210	115	20	0	0	0	0	0
2,350	2,375	18	0	0	0	309	214	119	24	0	0	0	0	0
2,375	2,400	23	0	0	0	313	218	123	28	0	0	0	0	0
2,400	2,425	27	0	0	0	318	223	128	33	0	0	0	0	0
2,425	2,450	31	0	0	0	322	227	132	37	0	0	0	0	0
2,450	2,475	35	0	0	0	326	231	136	41	0	0	0	0	0
2,475	2,500	40	0	0	0	330	235	140	45	0	0	0	0	0
2,500	2,525	44	0	0	0	335	240	145	50	0	0	0	0	0
2,525	2,550	48	0	0	0	339	244	149	54	0	0	0	0	0
2,550	2,575	52	0	0	0	343	248	153	58	0	0	0	0	0
2,575	2,600	57	0	0	0	347	252	157	62	0	0	0	0	0
2,600	2,625	61	0	0	0	352	257	162	67	0	0	0	0	0
2,625	2,650	65	0	0	0	356	261	166	71	0	0	0	0	0
2,650	2,675	70	0	0	0	360	265	170	75	0	0	0	0	0
2,675	2,700	74	0	0	0	365	270	175	80	0	0	0	0	0
2,700	2,725	78	0	0	0	369	274	179	84	0	0	0	0	0
2,725	2,750	82	0	0	0	373	278	183	88	0	0	0	0	0
2,750	2,775	87	0	0	0	377	282	187	92	0	0	0	0	0
2,775	2,800	91	0	0	0	382	287	192	97	2	0	0	0	0
2,800	2,825	95	0	0	0	387	291	196	101	6	0	0	0	0
2,825	2,850	100	5	0	0	391	295	200	105	10	0	0	0	0
2,850	2,875	104	9	0	0	396	299	204	109	14	0	0	0	0
2,875	2,900	108	13	0	0	401	304	209	114	19	0	0	0	0
2,900	2,925	112	17	0	0	405	308	213	118	23	0	0	0	0
2,925	2,950	117	22	0	0	410	312	217	122	27	0	0	0	0
2,950	2,975	121	26	0	0	415	317	222	127	32	0	0	0	0
2,975	3,000	125	30	0	0	419	321	226	131	36	0	0	0	0
3,000	3,025	129	34	0	0	427	327	232	137	42	0	0	0	0
3,025	3,050	134	39	0	0	436	336	241	146	51	0	0	0	0
3,050	3,075	138	43	0	0	445	344	249	154	59	0	0	0	0
3,075	3,100	142	47	0	0	455	353	258	163	68	0	0	0	0
3,100	3,125	147	52	0	0	464	361	266	171	76	0	0	0	0
3,125	3,150	151	56	0	0	474	370	275	180	85	0	0	0	0

Do not use this page if your income is wholly from salaries, wages, dividends, and interest

Schedule A.—INCOME FROM ANNUITIES OR PENSIONS

1. Cost of annuity (total amount you paid in)	$	4. Total amount received this year	$
2. Amount received tax-free in prior years		5. Excess, if any, of line 4 over line 3	
3. Remainder of your cost (line 1 less line 2)	$	6. Enter line 5, or 3 percent of line 1, whichever is greater (Attach separate schedule for each additional annuity or pension)	$

Schedule B.—INCOME FROM RENTS AND ROYALTIES

1. Kind of property	2. Amount of rent or royalty	3. Depreciation or depletion (explain in Schedule F)	4. Repairs (explain in Schedule G)	5. Other expenses (explain in Schedule G)
	$	$	$	$
Net profit (or loss) (col. 2 less sum of cols. 3, 4, and 5)	$	$	$	$

Schedule C.—PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION. (Farmers should obtain Form 1040F)

State (1) nature of business Dealer in chemicals ; (2) business name Philip J. LoBue Co.
(3) business address and D. & L. Chemical Products Co.

Do NOT include in this schedule cost of goods withdrawn for personal use or deductions not connected with business or profession.

1. Total receipts $ 395,677.84; Commissions and other $ 152.78 — $ 395,830 62

COST OF GOODS SOLD (To be used where inventories are an income-determining factor) (Enter the letters "C" or "C or M" on lines 2 and 8 if inventories are valued at either cost, or cost or market, whichever is lower)			OTHER BUSINESS DEDUCTIONS		
2. Inventory at beginning of year	$		11. Salaries and wages, not in line 4	$ 2,510	00
3. Merchandise bought for sale	350,095	59	12. Interest on business indebtedness		
4. Labor			13. Taxes on business and business property	56	26
5. Material and supplies			14. Losses (explain in Schedule G)		
6. Other costs Commissions (explain in Schedule G)	16,610	30	15. Bad debts arising from sales or services		
7. Total of lines 2 to 6	$ 366,705	89	16. Depreciation, obsolescence and depletion (explain in Schedule F)	467	68
8. Less inventory at end of year			17. Rent, repairs, and other expenses (explain in Schedule G)	12,722	26
9. Net cost of goods sold (line 7 less line 8)	$ 366,705	89	18. Amortization of emergency facilities (attach statement)		
10. Gross profit (line 1 less line 9)	$ 29,124	73	19. Net operating loss deduction (attach statement)		
			20. Total of lines 11 to 19	$ 15,756	20
			21. Total of lines 9 and 20	$ 382,462	09
			22. Net profit (or loss) (line 1 less line 21)		13,368 53

Schedule D.—GAINS AND LOSSES FROM SALES OR EXCHANGES OF CAPITAL ASSETS, ETC.

1. Net gain (or loss) from sale or exchange of capital assets (from separate Schedule D)	
2. Net gain (or loss) from sale or exchange of property other than capital assets (from separate Schedule D)	

Schedule E.—INCOME FROM PARTNERSHIPS, ESTATES AND TRUSTS, AND OTHER SOURCES

1. Name and address of partnership, syndicate, etc.	Amount,	$
2. Name and address of estate or trust	Amount,	
3. Other sources (state nature)	Amount,	
4. Total		
Total income from above sources (Enter as item 5, page 1)		$ 13,368 53

Schedule F.—EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED IN SCHEDULES B AND C

1. Kind of property (If buildings, state material of which constructed)	2. Date acquired	3. Cost or other basis (do not include land or other nondepreciable property)	4. Assets fully depreciated in use at end of year	5. Depreciation allowed (or allowable) in prior years	6. Remaining cost or other basis to be recovered	7. Estimated life used in computing depreciation	8. Estimated remaining life from beginning of year	9. Depreciation allowable this year
Office furn & fixt	1947	$ 1,129 85	---	$ ---	$1,129 85	10 yrs.		$ 82 88
Automobile	11-47	2,358 59	---	---	2,358 59	5 "		114 36
Leasehold Improv.	8-47	450 25	---	---	450 25	7-1/2	mos.*	270 14
*-Remaining period of lease								[illegible]

Schedule G.—EXPLANATION OF COLUMNS 4 AND 5 OF SCHEDULE B, AND LINES 6, 14, AND 17 OF SCHEDULE C

1. Column or Line No.	2. Explanation	3. Amount	1. Column or Line No.	2. Explanation	3. Amount
		$			$

16—82020-1 ★ GPO

Do not itemize deductions if—(1) You determine your tax from the tax table on page 4, or
(2) Your total income is $5,000 or more and you claim the $500 standard deduction.
If husband and wife living together at end of year file separate returns and one itemizes deductions, the other must file his or her return on Form 1040, and must also itemize deductions.

DEDUCTIONS

Describe deductions and state to whom paid. If more space is needed, list deductions on separate sheet of paper and attach to this return.		Amount
Contributions	Church	$ 175 00
	Red Cross, Community chest, T.B.League,	
	Fresh Air Fund and other organized charities	250 00
	Allowable Contributions (not in excess of 15 percent of item 6, page 1)	$ 425 00
Interest	Interest on mortgage - residence	$ 263 62
	Interest on life insurance loan	60 00
	Total Interest	323 62
Taxes	On residence	$ 282 30
	N. Y. C. Sales and other taxes including auto license	75 00
	Total Taxes	357 30
Losses from fire, storm, shipwreck, or other casualty, or theft.		$
	Total Allowable Losses (not compensated by insurance or otherwise)	
Medical and dental expenses		$
	Net Expenses (not compensated by insurance or otherwise)	$
	Enter 5 percent of item 6, page 1, and subtract from Net Expenses	
	Allowable Medical and Dental Expenses. See Instruction for limitation	
Miscellaneous		$
	Total Taxes	
Losses from fire, storm, shipwreck, or other casualty, or theft.		$
	Total Allowable Losses (not compensated by insurance or otherwise)	
Medical and dental expenses		$
	Net Expenses (not compensated by insurance or otherwise)	$
	Enter 5 percent of item 6, page 1, and subtract from Net Expenses	
	Allowable Medical and Dental Expenses. See Instruction for limitation	
Miscellaneous (See Instructions)		$
	Total Miscellaneous Deductions	
	TOTAL DEDUCTIONS	$ 1,105 92

TAX COMPUTATION—FOR PERSONS NOT USING TAX TABLE ON PAGE 4

1. Enter amount shown in item 6, page 1. This is your Adjusted Gross Income	$ 13,868 53
2. Enter DEDUCTIONS (if deductions are itemized above, enter the total of such deductions; if adjusted gross income (line 1, above) is $5,000 or more and deductions are not itemized, enter the standard deduction of $500)	1,105 92
3. Subtract line 2 from line 1. Enter the difference here. This is your Net Income	$ 12,762 61
4. Enter your exemptions ($500 for each person whose name is listed in item 1, page 1)	2,000 00
5. Subtract line 4 from line 3. Enter the difference here	$ 10,762 61
6. Use the tax rates in instruction sheet to figure your combined tentative normal tax and surtax on amount entered on line 5. Enter the tentative tax here. (If line 3, above, includes partially tax-exempt interest, see Tax Computation Instructions)	$ 2,929 79
7. Enter here 5 percent of amount entered on line 6, above	146 50
8. Subtract line 7 from line 6. Enter the difference here. This is your combined normal tax and surtax. (If alternative tax computation is made on separate Schedule D, enter here tax from line 12 of Schedule D)	$ 2,783 29

IF YOU USED THE $500 STANDARD DEDUCTION IN LINE 2, DISREGARD LINES 9, 10, AND 11, AND COPY ON LINE 12 THE SAME FIGURE YOU ENTERED ON LINE 8.

9. Enter here any income tax payments to a foreign country or U. S. possession (attach Form 1116)	$
10. Enter here any income tax paid at source on tax-free covenant bond interest	
11. Add the figures on lines 9 and 10 and enter the total here	
12. Subtract line 11 from line 8. Enter the difference here and in item 7, page 1. This is your tax	$ 2,783 29

10—63089-1

If you use this table, tear off this page and file only pages 1 and 2

TAX TABLE

FOR PERSONS WITH INCOMES UNDER $5,000 NOT COMPUTING TAX ON PAGE 3

Read down the shaded columns below until you find the line covering the total income you entered in Item 6, page 1. Then read across to the column headed by the number corresponding to the number of persons listed in Item 1, page 1. Enter the tax you find there in Item 7, page 1.

If total income in Item 6, page 1, is—		And the number of persons listed in Item 1, page 1, is—				If total income in Item 6, page 1, is—		Your tax is—								
At least	But less than	1	2	3	4 or more	At least	But less than									
$0	$5	$0	$0	$0	$0	$2,225	$2,250	$288	$193	$98	$3	$0	$0	$0	$0	$0
5	15	1	0	0	0	2,250	2,275	292	197	102	7	0	0	0	0	0
15	25	5	0	0	0	2,275	2,300	296	201	106	11	0	0	0	0	0
25	50	10	0	0	0	2,300	2,325	300	205	110	15	0	0	0	0	0
50	75	14	0	0	0	2,325	2,350	305	210	115	20	0	0	0	0	0
75	100	18	0	0	0	2,350	2,375	309	214	119	24	0	0	0	0	0
100	125	23	0	0	0	2,375	2,400	313	218	123	28	0	0	0	0	0
125	150	27	0	0	0	2,400	2,425	318	223	128	33	0	0	0	0	0
150	175	31	0	0	0	2,425	2,450	322	227	132	37	0	0	0	0	0
175	200	35	0	0	0	2,450	2,475	326	231	136	41	0	0	0	0	0
200	225	40	0	0	0	2,475	2,500	330	235	140	45	0	0	0	0	0
225	250	44	0	0	0	2,500	2,525	335	240	145	50	0	0	0	0	0
250	275	48	0	0	0	2,525	2,550	339	244	149	54	0	0	0	0	0
275	300	52	0	0	0	2,550	2,575	343	248	153	58	0	0	0	0	0
300	325	57	0	0	0	2,575	2,600	347	252	157	62	0	0	0	0	0
325	350	61	0	0	0	2,600	2,625	352	257	162	67	0	0	0	0	0
350	375	65	0	0	0	2,625	2,650	356	261	166	71	0	0	0	0	0
375	400	70	0	0	0	2,650	2,675	360	265	170	75	0	0	0	0	0
400	425	74	0	0	0	2,675	2,700	365	270	175	80	0	0	0	0	0
425	450	78	0	0	0	2,700	2,725	369	274	179	84	0	0	0	0	0
450	475	82	0	0	0	2,725	2,750	373	278	183	88	0	0	0	0	0
475	500	87	0	0	0	2,750	2,775	377	282	187	92	0	0	0	0	0
500	525	91	0	0	0	2,775	2,800	382	287	192	97	2	0	0	0	0
525	550	95	0	0	0	2,800	2,825	387	291	196	101	6	0	0	0	0
550	575	100	5	0	0	2,825	2,850	391	295	200	105	10	0	0	0	0
575	600	104	9	0	0	2,850	2,875	396	299	204	109	14	0	0	0	0
600	625	108	13	0	0	2,875	2,900	401	304	209	114	19	0	0	0	0
625	650	112	17	0	0	2,900	2,925	405	308	213	118	23	0	0	0	0
650	675	117	22	0	0	2,925	2,950	410	312	217	122	27	0	0	0	0
675	700	121	26	0	0	2,950	2,975	415	317	222	127	32	0	0	0	0
700	725	125	30	0	0	2,975	3,000	419	321	226	131	36	0	0	0	0
725	750	129	34	0	0	3,000	3,050	427	327	232	137	42	0	0	0	0
750	775	134	39	0	0	3,050	3,100	436	336	241	146	51	0	0	0	0
775	800	138	43	0	0	3,100	3,150	445	344	249	154	59	0	0	0	0
800	825	142	47	0	0	3,150	3,200	455	353	258	163	68	0	0	0	0
825	850	147	52	0	0	3,200	3,250	464	361	266	171	76	0	0	0	0
850	875	151	56	0	0	3,250	3,300	474	370	275	180	85	0	0	0	0
875	900	155	60	0	0	3,300	3,350	483	379	284	189	94	0	0	0	0
900	925	159	64	0	0	3,350	3,400	492	388	292	197	102	7	0	0	0
925	950	164	69	0	0	3,400	3,450	502	397	301	206	111	16	0	0	0
950	975	168	73	0	0	3,450	3,500	511	407	309	214	119	24	0	0	0
975	1,000	172	77	0	0	3,500	3,550	521	416	318	223	128	33	0	0	0
1,000	1,025	176	81	0	0	3,550	3,600	530	425	326	231	136	41	0	0	0
1,025	1,050	181	86	0	0	3,600	3,650	539	435	335	240	145	50	0	0	0
1,050	1,075	185	90	0	0	3,650	3,700	549	444	343	248	153	58	0	0	0
1,075	1,100	189	94	0	0	3,700	3,750	558	454	352	257	162	67	0	0	0
1,100	1,125	194	99	4	0	3,750	3,800	568	463	361	266	171	76	0	0	0
1,125	1,150	198	103	8	0	3,800	3,850	577	472	369	274	179	84	0	0	0
1,150	1,175	202	107	12	0	3,850	3,900	586	482	378	283	188	93	0	0	0
1,175	1,200	206	111	16	0	3,900	3,950	596	491	387	291	196	101	6	0	0
1,200	1,225	211	116	21	0	3,950	4,000	605	501	396	300	205	110	15	0	0
1,225	1,250	215	120	25	0	4,000	4,050	615	510	406	308	213	118	23	0	0
1,250	1,275	219	124	29	0	4,050	4,100	624	520	415	317	222	127	32	0	0
1,275	1,300	223	128	33	0	4,100	4,150	633	529	424	325	230	135	40	0	0
1,300	1,325	228	133	38	0	4,150	4,200	643	538	434	334	239	144	49	0	0
1,325	1,350	232	137	42	0	4,200	4,250	652	548	443	342	247	152	57	0	0
1,350	1,375	236	141	46	0	4,250	4,300	662	557	453	351	256	161	66	0	0
1,375	1,400	241	146	51	0	4,300	4,350	671	567	462	360	265	170	75	0	0
1,400	1,425	245	150	55	0	4,350	4,400	680	576	471	368	273	178	83	0	0
1,425	1,450	249	154	59	0	4,400	4,450	690	585	481	377	282	187	92	0	0
1,450	1,475	253	158	63	0	4,450	4,500	699	595	490	386	290	195	100	5	0
1,475	1,500	258	163	68	0	4,500	4,550	709	604	500	395	299	204	109	14	0
1,500	1,525	262	167	72	0	4,550	4,600	718	614	509	405	307	212	117	22	0
1,525	1,550	266	171	76	0	4,600	4,650	727	623	518	414	316	221	126	31	0
1,550	1,575	271	176	81	0	4,650	4,700	737	632	528	423	324	229	134	39	0
1,575	1,600	275	180	85	0	4,700	4,750	746	642	537	433	333	238	143	48	0
1,600	1,625	279	184	89	0	4,750	4,800	756	651	547	442	342	247	152	57	0
1,625	1,650	283	188	93	0	4,800	4,850	765	661	556	452	350	255	160	65	0
						4,850	4,900	774	670	565	461	359	264	169	74	0
						4,900	4,950	784	679	575	470	367	272	177	82	0
						4,950	5,000	793	689	584	480	376	281	186	91	0

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PHILIP J. LoBUE
SCHEDULE FOR TAX RETURN
1947

Rent, Repairs and Other Expenses

Rent	$ 870.00
Discounts Allowed	189.26
Secretarial Services	180.00
Telephone and Telegrams	777.09
Advertising	1,381.64
Freight, Expens and Storage	1,481.63
Auto Expenses, Travel and Entertaining customers at business and at home	5,940.69
Professional Fees	112.60
Office Supplies	440.74
Miscellaneous and Other Expenses	1,348.61
Total	$12,722.26

61

62 The Tax Court of the United States

Docket No. 41595

PHILIP J. LOBUE, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Official Report of Proceedings—October 14, 1953.

5050 Grand Central Terminal Bldg., 70 East 45th Street, New York, N. Y., Wednesday, October 14, 1953.

Met, pursuant to notice, at 12:00 o'clock noon.

Before: Honorable STEPHEN E. RICE, Judge.

Appearances:

Richard F. Barrett, Esq., 30 Federal Street, Boston, Mass., appearing for Petitioner.

John E. Mahoney, Esq., for District Counsel, Bureau of Internal Revenue, 60 Park Place, Newark, N. J., appearing for Respondent.

63 PROCEEDINGS

The CLERK: Docket 41595, Philip J. LoBue.

Mr. BARRETT: Ready for the petitioner.

The COURT: State your appearances, please.

Mr. BARRETT: Richard F. Barrett.

Mr. MAHONEY: Ready for the respondent. John E. Mahoney.

Mr. BARRETT: Shall I proceed, your Honor?

The COURT: Go ahead, Mr. Barrett.

Opening Statement of Mr. Barrett

Mr. BARRETT: This is an income tax case for the years 1946 and 1947. There is a single issue which I will describe briefly in a moment. The tax in controversy with respect to that issue is for the year 1946, $3031.63, and for the year 1947, $211.40.

This single issue is whether a plan to sell stock over a period of years by the allocation of rights to buy stock of a corporation to its employees resulted in compensation to the petitioner as one of the employees receiving these rights upon the exercise of the right. Using the term generally, it is a stock option case.

The facts are that the petitioner was employed by the employer corporation, the Michigan Chemical Corporation.

I should say, before I proceed with this brief statement, that almost all the facts appear in a stipulation which is to be a joint

stipulation, and there is to be one witness for the petitioner to add some oral testimony briefly.

64 These facts, which are in the stipulation, are that the petitioner was employed by the Michigan Chemical Corporation throughout the years 1944 to early in 1947. In 1944, the stockholders and directors of the corporation, the Michigan Chemical Corporation, passed resolutions with respect to a plan to sell stock over a period of years, ending in 1947, at a price of $5 per share to key employees to be selected from time to time.

In 1945, the following year, the petitioner had allocated to him the right to buy 150 shares at any time through March 1947 at $5 per share. Similar rights were granted to other employees under the plan in 1945.

This process was repeated in 1946, with respect to the petitioner and others, the petitioner getting the right to another 150 shares in 1946 on the same terms, expiring in 1947.

In 1947 again the petitioner was granted, along with other employees, a further right to buy stock, in this case 40 shares.

Now, one of the issues in the case is when the petitioner exercised these rights. In 1945, after the allocation of 150 shares to him, in that year he gave to the corporation his note for $750, representing 150 shares at $5 per share. He gave a note in 1946, subsequent to be allocated 150 shares at $5 per share; that

65 was the face amount of the note. These notes he paid in 1947. Perhaps I should verify that fact.

No; he paid the notes in 1946, and after payment of the notes in the two lots of 150 shares each, for which the notes were given, were delivered to him in 1946.

The 40 lot that was allocated to him, he gave no note for that and he paid for the stock shortly after the allocation, and the 40 shares were delivered to him in 1947.

The terms of the plan are set forth in the stipulation in the exhibits. The issue is one that has come before the Court repeatedly on options for these earlier years before the change in the law in 1950, whether the purpose of the options was to give the employees a proprietary interest in the company as shareholders or whether the purpose of the options was compensatory—in other words, to compensate them by virtue of receipt of the option for services rendered. And there are references to the purpose of the plan in the plan which has been stipulated to consist of the original resolutions of the stockholders and the directors in March of 1944, and letters written by Col. T. C. Davis, the Executive Head of the company—Executive Officer of the company—in these years, outlining the purpose and the details of the plan and their rights to the employees.

Those appear in the stipulation. These contain refer-
66 ences—and also in the annual reports to the stockholders, excerpts from which are part of the stipulation referring to this plan, there are references to the proprietary nature of it.

One factor that the Court is interested in is stipulated, as to the corporation taking a deduction for the spread between the option price and the market value in the years that the stock was delivered to the employees.

The COURT: You say the corporation did take a deduction?

Mr. BARRETT: The corporation did take a deduction. We are going to have testimony from Col. Davis, who is my witness, my single witness, on that in a moment.

About the only other thing I think might be of interest to you in hearing this brief testimony is the fact which the Court has been interested in in prior years, as to whether there was any spread between the option price and the market value at the time that the plan was adopted; and in this case there was not.

I think it would be imposing on the Court, in view of the clarity of the facts in the stipulation in detail, to proceed further with any detail, unless you would like to have me do so.

The COURT: No, I think that is sufficient.

Opening Statement of Mr. Mahoney

Mr. MAHONEY: This case involves the question whether the pe-
67 titioner was in receipt of income in the taxable years 1946 and 1947 by virtue of the purchase of stock of his employer, the Michigan Chemical Corporation, during those years.

The corporation decided in 1944 to set aside 10,000 of its unissued stock for purchase by its employees. The method of distribution and the decision as to which employees were to receive the rights to purchase stock was in the hands of a committee of the Board of Directors.

In 1945, the petitioner was notified that he was eligible to purchase 150 shares with certain limitations which are stated in Exhibit 4-D, Stipulation of Facts.

In January 1946, the petitioner was notified that he was eligible to purchase an additional 150 shares. In January 1947, the petitioner was notified that he had been allotted 40 shares of stock.

All shares were to be purchased at $5 per share.

The respondent has determined that the spread between the price of $5 and the market value at the time the stock was purchased was compensation to the petitioner under Section 22(a) of the Internal Revenue Code.

As to the exercise of the petitioner's rights, the respondent would like to point out this being previously unissued stock, both under

the terms of the letters allotting the stock to the petitioner, and also under the Laws of Michigan, that no stock could be
68 issued to the petitioner until paid for.

In May 1946, the petitioner paid for 300 shares of stock, by a check in the amount of $1500.

The market price at that time has been stipulated at $30.50 per share, and the amount of the deficiency has been determined upon the spread at that time.

It has been stipulated that the employer, Michigan Chemical Corporation, took a deduction in its income tax returns for the taxable years 1946 and 1947 for the stock issued under these purchase rights to employees.

It has also been determined that the petitioner was in receipt of $580 of additional income for the 40 shares purchased in 1947.

At this time I would like to offer the Stipulation of Facts which counsel has referred to, into which we both enter.

The COURT: It will be received.

All right, Mr. Barrett.

Mr. BARRETT: Col. Davis, would you take the stand, please.

Whereupon, T. C. DAVIS was called as a witness by and on behalf of the petitioner, and being first duly sworn, was examined and testified as follows:

69 The CLERK: State your name and address, please.

The WITNESS: My name is T. C. Davis, Mill Street, St. Louis. Michigan.

DIRECT EXAMINATION.

By Mr. Barrett:

Q. Colonel Davis, are you associated at the present time with the Michigan Chemical Corporation?

A. Yes, I am a director.

Q. How long have you been associated with the Michigan Chemical Corporation?

A. Since March of 1941.

Q. Would you please tell us the capacity in which — have been associated with the Corporation during these years?

A. Well, I have served as a director since March of 1941 and was Executive Vice President, I think, in 1944 and President from about—from March of 1946 through 1948, or either March of 1949, when I became Chairman of the Board. Then I gave that up in 1949 or 1950, I have forgotten which, and have been—remained on the Board as a director.

Q. During the years 1944 through 1947, did you serve as the operating head of the company? That is, its Chief Executive Officer?

A. Yes. There was a President, Mr. Morris was President for the earlier part of that time. He died in February of 1946.

70 Q. Are you familiar with the so-called stock option plan which was adopted at meetings of the stockholders and the Board of Directors on March 21, 1944?

A. I am.

Q. What was your connection with this plan prior to the passing of those resolutions by the stockholders and the directors?

A. Well, it was my idea that we should provide some means to have our key employees have a proprietary interest in the company, because it has always been my feeling that it is better for a company and better for the employees.

I discussed it with the directors and officers of the company and proposed it to the stockholders' meeting in 1944.

Q. Who was the person that initiated that plan and under whose supervision was it drawn up?

A. I think I was.

Q. You were. In these discussions with the directors and with the officers of the company, prior to the passing of the resolutions of March 21, 1944, was there any characterization of the plan in your recollection as being intended as compensation to the employees?

A. Not the slightest.

Q. Subsequent to March 21, 1944, the day of the passing of the resolutions of the stockholders and directors referred to and

71 throughout the years 1944, 1945, 1946 and 1947, were there further discussions among the directors and officers in which you took part, with respect to the objectives and intent of the plan?

A. Yes.

Q. In these discussions referred to in the preceding question, do you recall any instance of a director or an officer characterizing the plan as having the objective of providing compensation for the employees?

A. Never.

Q. Have you read this stipulation of facts, Colonel Davis?

A. Yes, this morning.

Q. And you are generally familiar with its contents? The stipulation of facts in paragraph 21 reads as follows:

"For its taxable years ended December 31, 1946 and December 31, 1947 the corporation deducted on its income tax returns amounts described as the excess of market value at exercise date of option price of 3900 shares of said stock sold to employees during 1946, and 5665 shares of said stock sold to employees during 1947 in the

respective amounts of $81,372.50 and $81,398.25, which deductions were not recorded on its books."

In or about February or the early part of March, 1947, did you attend a conference in Detroit at the Detroit office of Ernst & Ernst, public accountants?

72 A. Yes.

Q. Were Ernst & Ernst at that time the public accountants for the Michigan Chemical Corporation?

A. Yes.

Q. Would you describe to the Court—I will withdraw that question.

What was the ocasion for your being in their office at that time?

A. I got in Detroit that morning and went to their office around —well, I guess I got in there after the morning because I went in there in the afternoon, and to review their figures for the annual report. And of course I had to sign that report, being then the President of the company.

And they told me at that time they were setting up this figure that you have mentioned as a tax deduction. And I said, "Well, that can't be done because this is not a compensatory situation. These men are not to be compensated and this is not compensation, and you just can't do this," but——

Q. That was the occasion for your being present. Now, on this occasion was there a discussion with you in which the accountants took part on the question of taking a deduction on the 1946 calendar year tax return of the company?

A. May I have that question again, please, sir?

73 Q. Was there a discussion on this occasion between you and the accountants of the question of taking a deduction on the 1946 tax return of the corporation?

A. Yes.

Q. With respect to these options?

A. Yes.

Q. What was the substance of that discussion?

A. Well, they presented this matter to me, which was entirely new. I had had no indication and no inkling, although they had been working on the books for some months before that, preparing for this report, that they had intended to make any such calculation or stipulation or transaction on the books of the company, or in its reports.

I argued as strongly as I could this should not be done, and they came—they said they had gotten it for the prior year and they felt it must be done this year because it was according to good tax accounting principles.

So I finally acquiesced. It was 5 o'clock in the evening. That report had to go to the printers that night in order to get out under

the requirements of the 10-day period prior to the publication—I mean, to the stockholders—to the annual meeting.

Q. Did you say "prior to the publication of the annual stockholders' report"?

A. That's right.

74 Q. Prior to this conference referred to in your previous answer, had you had any discussions with any of the officers or directors of the Michigan Chemical Corporation with respect to taking a deduction on the Federal income tax return?

A. No.

Q. For these options?

A. No.

Q. What was your objection to the position taken by the accountants at the conference referred to?

A. My objection was primarily this was not compensation; this was an incentive plan. That was all it was for, and to date these men have a proprietary interest in the company.

Mr. BARRETT: No further questions. That is all, if your Honor please.

CROSS-EXAMINATION.

By Mr. Mahoney:

Q. Colonel, I would like to read a few paragraphs to you to refresh your recollection, and I am referring to your letter to Philip LoBue dated January 18, 1945, attached to the stipulation of facts as Exhibit 4-D.

"I am pleased to advise you that the operations of the company, though leaving much to be desired, were moderately profitable for the year 1944. The tentative allotment of stock made to

75 you last June has now been changed. Subject to the above conditions, you are definitely allotted 150 shares of the unissued common stock of the Michigan Chemical Corporation. This allotment of stock was made by the committee and is in recognition of your contribution and efforts in making the operation of the company successful."

I will skip one paragraph, to the next paragraph:

"As you know, we must continue to contribute our every effort toward the success of Michigan Chemical Corporation. There is much yet to be done to bring this company along toward the attainment of our goal. This will require the most intensive work on the part of all of us during the current year."

I will skip over to the next letter of January 1, 1946, Exhibit 5-E in the stipulation of facts, and I read:

"The Committee's selection of the names of our employees to receive the right to purchase stock and the number of shares as-

signed to each selectee is determined by the Committee after a careful appraisal of the individual's contributions to the company in the way of job performance during the past year. In other words, the extent of your participation in the plan is based on how well you handled your job during the year. Outstanding service to the company is given added recognition in determining the number of shares assigned. In this connection, I would like to point out to you it is but natural to expect a more rigid
76 comparative appraisal of your efforts in the future."

After hearing those two excerpts or those paragraphs read which were contained in your letters, would you still say that this plan of distribution of stock was not compensatory?

A. I do.

Q. You have testified regarding discussions with accountants as to the taking of deductions by the corporation of the spread between the amount of the price paid by the employee and the market value at the time it was given to them. It is a matter of fact that the corporation did take those deductions in 1946 and 1947, is it not?

A. My recollection is that they did, but my recollection also is that they were never—they never worked out in the tax return. That is, that we had other losses that were such that there was no advantage gained by the company. That is my recollection of it, sir.

Q. Sir, if I told you that we have stipulated, and this is on the basis of the tax returns of the corporation, that in the year 1946 the corporation deducted $81,372.50 and in the year 1947 the corporation deducted $81,398.25, and I ask you now, the corporation still took as a deduction this spread on the stock that was issued to its employees, did it not?

77 A. As far as I know, it did. I don't have the reports.

Q. I am sorry, I didn't mean to interrupt you. Have you finished?

A. Yes.

Q. Would your feeling in this matter as to the fact these shares should be compensatory or not have anything to do with the 5000 shares of stock that was issued to you?

A. I had nothing to do——

Mr. BARRETT: Just a minute, your Honor. I object to that question. I don't think that came within the scope of the direct examination.

The COURT: All right.

Mr. MAHONEY: If your Honor will allow me, the witness testified

that "it was my idea"—the terminology he used—"that these employees should be given a proprietary interest."

I am trying to find out whether his idea was arrived at because of the fact he may have some stock interest which may be compensation to him, also.

The WITNESS: No. May I please explain that?

Mr. BARTLETT: Just a minute, Colonel Davis.

If the Court will permit me, Colonel Davis is not a participant in this plan and none of the direct examination related to anything that had to do with stock sold to him.

78 The COURT: What is it you are trying to show by this witness?

Mr. MAHONEY: I am trying to show whether the Colonel's idea that the issuance of stock to these employees should be proprietary rather than compensation was derived through any feeling as to any stock that he may have obtained.

The COURT: I am pretty sure I know what his answer will be, but I will let him testify to it.

Objection overruled.

Can you answer?

The WITNESS: Shall I answer?

The COURT: Yes.

The WITNESS: At the time this option was granted by the stockholders of the amount of 10,000 shares was set aside to be distributed to key employees, the stock was then selling around $4.50 to $5—we considered it approximately $5. When I proposed this in the stockholders' meeting, the stockholders adopted it.

Then they—then one stockholder got on the floor and said he wanted to give to T. C. Davis an option for 5000 shares.

I said at that time, "I do not want the option and I cannot participate in this 10,000 shares option and it should not be done."

But they overrode me and they did it anyway, at that

79 time. I later took up this 5000 shares within the year.

This was a—your Honor, this was a company that had little capital and was a very small company. When we went in there years before, in 1941, the company had no capital to speak of, very small business. In fact, I think, if I recall right, the sales for the year 1941 were $400,000, and Mr. Morris and I and our associates took an option on the 100,000 shares of stock to provide capital for this company to try to build it up. That was in 1941.

We took that option at $5 a share, although the stock in the market was at that time selling at 2⅛.

I set the price at $5 a share, or at the—I suggested it to the Board, or at least I suggested it to the Board at that time, because they had warrants out.

This thing had been financed and re-financed several times and they had warrants out at $5 a share and I knew it was going to take quite a number of years to get the company around to where it could possibly do anything in the way of making money for its stockholders.

We finally exercised this 100,000 allotment. That is, we took up so much as the company needed it in the expansion of its business. And the 5000 shares that were voted me at that time I didn't want because I had all the stock I wanted in this 100,000 share allotment. But, anyway, they did it despite that and I took up the option within the year.

80 That has nothing to do with the 10,000 shares or the incentive plan to the employees.

Mr. MAHONEY: No further questions.

REDIRECT EXAMINATION.

By Mr. BARRETT:

Q. Colonel Davis, did you report on your income tax returns any compensation that related to this option that was given to you?

A. I certainly did not.

Q. And was exercised by you?

A. I did not.

Q. Was any tax proposed to be assessed against you?

A. Yes.

Q. What was the outcome of that proposal?

A. It was decided that there would be no tax.

Mr. BARRETT: Thank you. No further questions.

Mr. MAHONEY: No further questions.

The WITNESS: The examiner—the—I don't know—the tax office in Detroit——

By Mr. BARRETT:

Q. Dropped the case?

A. Dropped the case.

Q. Without any deficiency being assessed—without a tax being assessed?

A. Yes.

81 RECROSS EXAMINATION.

By Mr. MAHONEY:

Q. Was there a tax court decision on it?

A. No.

Q. Or was it settled?

A. No, it never went to the tax court. I don't know the terms that—the titles of the people, but the Detroit office of the Internal Revenue Department, I went and appeared there and they dropped the case completely and gave me——

The COURT: They agreed with you it was not compensation?

The WITNESS: They agreed that it was not compensation, yes, sir.

Mr. BARRETT: No further questions. You may step down now.

(Witness excused)

Mr. BARRETT: Your Honor, I would now like to offer the copies of the annual reports of the Michigan Chemical Corporation, annual reports to stockholders for the years 1944 through 1947, which I can have identified by calling Colonel Davis back to the stand, if Mr. Mahoney objects to the authenticity of them.

Mr. MAHONEY: I do not object to the authenticity of them, your Honor, but I do object to their going into evidence as immaterial, impertinent, and irrelevant. And I say that on the grounds

82 we have stipulated, starting with paragraph 23, going through paragraph 28, as to the material parts of those annual reports. I feel that this is totally immaterial to this case and has no bearing on it at all.

The COURT: What is it you want to show by it?

Mr. BARRETT: I want to put them in, your Honor. I didn't want to propose them as exhibits previously and had not; but Colonel Davis, in response to Mr. Mahoney's question about his participation, gave to the Court a lot of detailed facts about warrants and his 5000 shares and material that will not be clear to the Court without the explanation of the matters that appear in here.

The COURT: I will let it in.

Mr. MAHONEY: The witness has already testified to this 5000 shares, that it had no bearing on this 10,000 share transaction.

The COURT: I understand. Objection overruled. They may be received in evidence.

Mr. MAHONEY: Are they one exhibit or several?

Mr. BARRETT: There are four of them.

The COURT: Four separate exhibits.

(Petitioner's Exhibits 14, 15, 16, and 17 were received in evidence.)

The COURT: Does that conclude your case?

83 Mr. BARRETT: It does, your Honor.

The COURT: How much time would you like for briefs?

Mr. MAHONEY: May I, your Honor—I still have two returns I would like to offer.

I offer in evidence the 1946 individual return of Philip J. LoBue. Any objection?

Mr. BARRETT: No.

The COURT: Received in evidence.

(Respondent's Exhibit N was received in evidence.)

Mr. MAHONEY: I offer the individual 1947 income tax return of Philip J. LoBue. Any objection?

Mr. BARRETT: No.

The COURT: Received in evidence.

(Respondent's Exhibit O was received in evidence.)

Mr. MAHONEY: I request permission to withdraw the last two exhibits and substitute photostatic copies.

The COURT: Permission granted.

Mr. MAHONEY: Respondent rests.

The COURT: How much time do you want for briefs?

Mr. MAHONEY: May I have 75 days?

The COURT: All right. Simultaneous briefs. Original briefs 75 days and reply briefs in 20 days. Mr. Jones will give you

84 the dates.

The CLERK: Original briefs December 28th and reply briefs January 18, 1954.

(Whereupon, at 12:40 o'clock p. m., Wednesday, October 14, 1953, the hearing in the above-entitled matter was concluded.)

85 (File endorsement omitted)

The Tax Court of the United States

(Title omitted)

MOTION AND ORDER EXTENDING TIME TO FILE RESPONDENT'S BRIEF

Comes now the Commissioner of Internal Revenue, by his attorney, Daniel A. Taylor, Chief Counsel, Internal Revenue Service, and moves the Court for an extension of time from December 28, 1953 to January 18, 1954, in which to file respondent's brief in the above proceeding.

In support of this motion, it is respectfully shown that the respondent's brief is due December 28, 1953; that the brief has been

prepared and is under review; and that because of the pressure of work in the Washington office additional time is being requested.

WHEREFORE, it is prayed that this motion be granted.

DANIEL A. TAYLOR,
Chief Counsel,
Internal Revenue Service.

Of Counsel:
JOHN T. ROGERS,
Regional Counsel,
JAMES C. MADDOX,
Appellate Counsel.
JOHN E. MAHONEY,
HUGH B. MUIR,
Special Attorneys,
Internal Revenue Service.

86 (File endorsement omitted.)

(Title omitted)

In the Tax Court of the United States

Granted. The Tax Court of the U.S., Feb. 5, 1954. Stephen E. Rice, Judge.

MOTION AND ORDER EXTENDING TIME TO FILE REPLY BRIEF

Comes now the petitioner, by his attorney, Richard F. Barrett, and moves the court for an extension of time from February 7, 1954, to February 26, 1954, in which to file petitioner's reply brief in the above proceeding.

In support of this motion, it is respectfully shown that due to the excessive pressure of other work at this time it is impossible to prepare an adequate and proper reply brief in the time allowed.

Wherefore, it is prayed that this motion be granted.

Respectfully submitted,

RICHARD F. BARRETT,
30 Federal Street,
Boston 10, Massachusetts,
Counsel for Petitioner.

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22 T. C. No. 58

The Tax Court of the United States

PHILIP J. LOBUE, PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 41595

Filed May 28, 1954

In 1945, 1946, and 1947, petitioner was granted options to purchase his employer's stock. When petitioner received the stock in 1946 and 1947, its fair-market value exceeded the option price. The options were granted to give petitioner a proprietary interest in the Corporation, and not as additional compensation.

Held, petitioner received no taxable compensation in 1946 and 1947 upon receipt of the stock. T.D. 5507, 1946-1 C.B. 18, and I.T. 3795, 1946-1 C.B. 15, to the contrary, are not justified by *Commissioner* v. *Smith,* 324 U.S. 177 (1945).

Richard F. Barrett, Esq., for the petitioner.
John E. Mahoney, Esq., for the respondent.
(Seal)

FINDINGS OF FACT AND OPINION—May 24, 1954

This proceeding involves deficiencies in income tax, as follows:

Year	*Deficiency*
1946	$3,088.63
1947	464.11

88 The issues to be determined are: (1) whether the exercise of stock options by petitioner resulted in taxable compensation to him in 1946 and 1947; and (2) if so, in what amounts. Other adjustments made in the deficiency notice have not been contested, and will be taken into account under a Rule 50 computation.

Some of the facts were stipulated.

FINDINGS OF FACT

The stipulated facts are so found and are incorporated herein.

The petitioner is a resident of Leonia, New Jersey, and filed his

Federal income tax returns for the years in question with the collector of internal revenue for the fifth district of New Jersey.

The petitioner was employed by the Michigan Chemical Corporation (hereinafter referred to as the Corporation) as manager of the New York Sales Division from September 1941 to February 28, 1947, at which time his employment terminated. There was no written contract covering the terms and conditions of his employment. His salary was $500 per month in 1944 and 1945, and $550 per month in 1946 and 1947. The nature and extent of his duties remained the same throughout his employment.

The Corporation was organized in 1935, and was engaged in the business of producing and selling chemical products. One T. C. Davis had been a director and executive vice-president of the Corporation since 1941. In 1946 he became president, and in 1949 chairman of the board. From 1944 through 1947, he was the company's chief executive officer. Prior to 1944, Davis felt that the Corporation should provide some means to give its key em-
89 ployees a proprietary interest in it, because of his long standing belief that both the company and employees profited from employee stock-ownership. Davis discussed his ideas with the directors and officers of the Corporation, and proposed at a stockholder's meeting on March 21, 1944, that key employees be given an option to purchase stock. On that date the shareholders of the Corporation approved a plan of its board of directors, whereby 10,000 shares of its common stock were to be made available to certain key employees of the Corporation over the ensuing 3 years. The option price was $5 per share, and the fair-market value of the stock at that time was $4.50. The sale of the stock to the employees was authorized by the Michigan Corporation and Securities Commission on June 15, 1945.

On June 29, 1944, the executive vice-president of the Corporation addressed a letter to petitioner advising him of the action of the stockholders and board of directors in March of that year. The letter stated:

> * * * The purpose of this is to provide an incentive to key employees and especially to permit such men to participate in the success of the Company. This is a method or plan which has been followed by many of the leading American corporations.
>
> * * * * * * *

The letter further stated that petitioner was to be tentatively allotted an option to purchase 10 shares of stock; that the option could not become definite until January 1, 1945, depending upon the company's profitable operations for the remainder of the year 1944. The letter further stated that receipt of the option was con-

tingent upon petitioner's being employed by the company on June 30, 1945.

90 On January 18, 1945, another letter from the executive vice-president of the Corporation to petitioner granted him an option to purchase 150 shares of stock on June 30 of that year. The rights to subscribe to the stock were not transferable. The letter also stated:

* * * * * * *

> As you know, we must continue to contribute our every effort toward the success of Michigan Chemical Corporation. There is much yet to be done to bring the Company along towards the attainment of our goal. This will require the most intensive work on the part of all of us during the current year. That we have a great opportunity is, I am sure, well known to you.

* * * * * * *

On May 1, 1945, petitioner gave the Corporation his promissory note for $750, covering the purchase price of the 150 shares allotted to him. The Corporation had granted similar option rights to 36 other key employees in 1945.

A letter from the executive vice-president of the Corporation, dated January 1, 1946, granted petitioner an option to purchase an additional 150 shares of stock. The letter stated:

* * * * * * *

> I am sure you recognize that there is much waste in most of our operations. Waste of materials, steam, water and of still greater importance the waste of time and labor. You should make every effort to correct these faults and where you know them to exist in parts of the plant beyond your control, you should not hesitate to point them out to those responsible.

* * * * * * *

On January 3, 1946, petitioner gave the Corporation his promissory note, in the amount of $750, covering the purchase price of the 150 shares. In 1946 the Corporation granted similar option rights to 47 other key employees. On May 24, 1946, petitioner paid his two notes in the total amount of $1,500, and received 300 shares of stock.

91 On January 2, 1947, the president of the Corporation advised the petitioner that he had been granted the option to purchase 40 additional shares of the Corporation's stock. The president's letter stated:

* * * * * * *

> Again I wish to call your attention to the fact that these allocations afford you an opportunity to become a stockholder and thus participate in the future earnings of the corporation. The future progress and earnings of the corporation are largely dependent upon the loyal cooperation and efforts of each of its employees. The corporation's plans for 1947 include further expansion which should bring to you greater opportunities for participation in the future of your company both as an employee and stockholder. Incidentally, an employee should feel a certain amount of pride in also being a stockholder.

* * * * * * *

The Corporation, in 1947, granted additional option rights to 75 other key employees. On February 3, 1947, petitioner paid the Corporation $200 and received a certificate for 40 shares of its stock.

No deduction was taken by the Corporation on its income tax return for the year ending December 31, 1945, for the difference in the fair-market value and the option price of stock options granted to employees in that year.

On its income tax returns for the years ending December 31, 1946, and December 31, 1947, the Corporation deducted an amount described as the excess of market value at exercise date over option price of 3,900 shares of stock sold to employees in 1946 and 5,665 shares sold to employees in 1947.

The fair-market value of the Corporation's stock at certain times during the 3-year period, 1944-1947, was as follows:

92

Year	*Fair-Market Value*
March, 1944	$ 4.50
January, 1945	8.69
May, 1945	13.25
June, 1945	14.38
January, 1946	19.25
April, 1946	25.25
May, 1946	30.50
February, 1947	19.50

The number of stockholders, from 1940 to 1947, was as follows:

Year	*Number of Stockholders*
1940	436
1941	423
1942	435
1943	432
1944	451
1945	665
1946	871
1947	1,132

In his deficiency notice, the respondent determined that petitioner received additional unreported compensation in the amount of $8,100 from the exercise of the option in 1946 and $580 from the exercise of the option in 1947.

The options granted to petitioner in 1945, 1946 and 1947 were to give him a proprietary interest in the Corporation, and not as compensation for services.

OPINION

RICE, *Judge*: Petitioner argues that the stock options given to him in 1945, 1946, and 1947 were granted by the Corporation for the purpose of providing him with a proprietary interest in the business, and were not intended as additional compensation to be received when he exercised them.

93 If the options were intended as additional compensation, the excess of the fair-market value over the option price is taxable income to him when the option is exercised. *Commissioner v. Smith*, 324 U.S. 177 (1945). If the option were granted to provide him with a proprietary interest in the business, no taxable gain is recognized when the options are exercised. *Abraham Rosenberg*, 20 T. C. 5 (1953); *Norman G. Nicholson*, 13 T. C. 690 (1949). This is a question of fact. *Abraham Rosenberg*, *supra*. We have found that the stock options were granted to petitioner for the purpose of providing him with a proprietary interest in the business. We shall elaborate presently on our findings.

The respondent recognizes the factual nature of the question presented with respect to the option granted to petitioner in January 1945. He argues, however, with respect to the options granted in January 1946 and 1947, that T.D. 5507, 1946-1 C.B. 18, and I.T. 3795, 1946-1 C.B. 15, automatically require the excess of the fair-market value of the stock over the option price paid for it to be taxed as compensation.

T.D. 5507, *supra*, provides that if property is transferred by an employer to an employee, for an amount less than its fair-market

value, the difference between the amount paid for the property and the amount of its fair-market value is in the nature of compensation, and shall be included in the gross income of the employee.

I.T. 3795, supra, further provides that if an employee receives an option, on or after February 26, 1945, to purchase the stock of his employer corporation and the employee exercises that
94 option, he realizes taxable income by way of compensation to the extent that the fair-market value of the stock when received exceeds the option price paid for it.

In essence, respondent's argument with respect to the mandatory effect of T.D. 5507, *supra*, and I.T. 3795, *supra*, is to say that we may not consider the factual question of whether the options granted to petitioner in 1946 and 1947 were or were not intended as compensation. In *Harley* v. *McNamara*, 19 T.C. 1001 (1953), reversed on other grounds——F. 2d——(C.A. 7, February 23, 1954), involving an option granted after February 26, 1945, we did consider the factual question whether the option was intended as compensation; but, since we determined that it was so intended, we found it unnecessary to consider whether T.D. 5507, *supra*, and I.T. 3795, *supra*, were justified by *Commissioner* v. *Smith*, *supra*, or were otherwise valid.

The Commissioner promulgated the rulings in question on the assumption that the *Smith* case held that any economic or financial benefit conferred on an employee was compensation, regardless of the form or mode by which the benefit was conferred. The *Smith* case does not so hold. Therein the Supreme Court upheld a finding of fact by this Court that a stock option was intended as additional compensation and in doing so, stated, page 181:

> Section 22 (a) of the Revenue Act is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected. * * *

This language does not support the Commissioner's amendment to the regulations that any stock option granted to an employee after February 26, 1945, results in taxable compensation,
95 when exercised, to the extent that the fair-market value of the stock at that time exceeds the option price paid.[1]

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[1] In considering the Revenue Act of 1950, Congress established a new set of rules for the tax treatment of certain employees stock-options. In doing so, it recognized that such options were frequently used as an incentive device by corporations who wished to attract new management, to convert officers into "partners" by giving them a stake in the business, and generally to give their

Determination of whether a stock option is granted to an employee as additional compensation, or to give him a proprietary interest in the Corporation, thus remains a question of fact. In reaching that conclusion, we think the criteria set forth by this Court in *Delbert B. Geeseman*, 38 B.T.A. 258 (1938), is still the most reliable guide to be followed. In the *Geeseman* case, we said, at page 264:

> * * * as a prerequisite to the conclusion sought by the respondent it should definitely and clearly appear that a transaction, which in form is nothing more than a purchase and to an obvious and substantial extent is unquestionably a purchase, is in fact to some extent the payment of compensation for services rendered or to be rendered.

Here it "definitely and clearly" appears that the granting of the options to petitioner in 1945, 1946, and 1947 was not intended as additional compensation for his services.

96 The essential purpose of the Corporation's action in initially authorizing the allocation of 10,000 shares to be sold to employees, as indicated by the vice-president's letter of June 29, 1944, and as amplified by his testimony at the trial, was to provide the key employees with an incentive to promote the growth of the company by permitting them to participate in its success. The annual report of the Corporation for the year ended December 31, 1947, emphasizes the growth in the number of shareholders after the employee-purchase option plan was adopted. In the 4-year, 1944 to 1947, inclusive, the number of shareholders more than doubled.

The vice-president's and president's letters to petitioner, notifying him of the granting of the stock options, emphasized the Corporation's problems and encouraged his cooperation and help in their solution. The tenor of these letters bespeaks appeal to a pro-

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employees a more direct interest in the success of the corporation. It realized that the regulations here in question often worked a real hardship on employees when stock options were exercised, since an immediate sale of a portion of the stock was necessary frequently to pay the tax; and that when such a sale was necessary, it reduced the effectiveness of the option as an incentive device. In its Report on the Revenue Act of 1950, the Senate Finance Committee stated:

> At the present time the taxation of these options is governed by regulations which impede the use of the employee stock option for incentive purposes. Moreover, your committee believes these regulations go beyond the decision of the Supreme Court in *Commissioner* v. *Smith*, 324 U.S. 177 (1945). * * * [S. Rept. No. 2375, 81st Cong. 2d Sess. (1950), p. 59.]

prietary interest in the Corporation's welfare and growth rather than to a mere employee's interest.

The fact that the purchase price initially specified by the directors in granting the option rights slightly exceeded the then fair-market value of the stock negates the idea that the rights were authorized with compensation in mind.

We observed in *Delbert B. Geeseman, supra,* page 263, that in practically all such cases as the one before us, both the element of additional compensation and the granting of a proprietary interest are present. We said, however, that decision would be impossible "if the absence of one or the other is essential thereto".

97 The respondent attaches considerable significance to the fact that Corporation, in 1946 and 1947, claimed a deduction on its income tax returns for the difference in the fair-market value and the option price at which the stock was purchased by the employees in those years. The Corporation did not claim a deduction in 1945, but did in 1946 and 1947. We do not think the deductions in the latter years are binding on petitioner, and do not change the essential purpose which motivated the granting of the option rights. *Abraham Rosenberg, supra; Estate of Lauson Stone,* 19 T.C. 872 (1953), affd. 210 F. 2d 33 (C.A. 3, 1954); and *Delbert B. Geeseman, supra.*

Reviewed by the Court.

Decision will be entered under Rule 50.

VAN FOSSAN, MURDOCK, HARRON, AND RAUM, *JJ.*, dissent.

98 (File endorsement omitted.)

The Tax Court of the United States

(Title omitted.)

RESPONDENT'S COMPUTATION FOR ENTRY OF DECISION

(Filed July 8, 1954)

The attached computation reflecting deficiencies in income taxes in the amounts of $57.00 and $252.71 for the taxable years 1946 and 1947, respectively, is submitted on behalf of the respondent in compliance with the opinion of the Court determining the issues in this proceeding.

The computation is submitted without prejudice to the respondent's right to contest the correctness of the decision entered

herein by the Court pursuant to the statute in such cases made and provided.

DANIEL A. TAYLOR,
Chief Counsel,
Internal Revenue Service.

OF COUNSEL:

CECIL H. HAAS,
Regional Counsel,
FRANCIS X. GALLAGHER,
Special Assistant to the Regional Counsel,
JOHN E. MAHONEY,
Attorney, Internal Revenue Service.

Without prejudice to the right of appeal, it is agreed that the attached computation is in accordance with the opinion of the Tax Court in the above-entitled proceeding.

RICHARD F. SAMUEL,
Counsel for Petitioner.

99

ARC-Ap: PHI
Nwk: EPB

COMPUTATION STATEMENT

In re: Philip J. LoBue,
Leonia, New Jersey.
Docket No. 41595.

Income Tax

Year	Deficiency
1946	$ 57.00
1947	252.71

The details supporting the above computation are shown in the attached pages 2 and 3.

100

Philip J. LoBue — Taxable Year Ended December 31, 1946

Net Income

Net income as determined in notice of deficiency dated March 12, 1952	$17,536.40
Less: Compensation	8,100.00
Net income as now determined	$ 9,436.40

Explanation of Adjustment

Based upon the opinion of The Tax Court of the United States, promulgated May 28, 1954, amounts received in 1946 and 1947 from the exercise of an option to purchase Michigan Chemical Corporation stock are considered nontaxable. Net income is therefore reduced by these amounts, namely $8,100.00 in 1946 and $580.00 in 1947.

Computation of Income Tax

Net income as now determined		$9,436.40
Less: Exemptions		2,000.00
Balance subject to tax		$7,436.40
Tentative tax on $7,436.40		$1,790.92
Less: 5% of $1,790.92		89.55
Income tax liability		$1,701.37
Less: Tax withheld from wages	$ 784.80	
Payments on Declaration of Estimated Tax	971.20	
Tax assessed, Original Account, No. 9085479	None	
Total	$1,756.00	
Less: Credit allowed, Sch. IT-D-90854	111.63	1,644.37
Deficiency of income tax		$ 57.00

101

Philip J. LoBue — Taxable Year Ended December 31, 1947

Net Income

Net income as determined in notice of deficiency dated March 12, 1952	$14,042.61
Less: Compensation	580.00
Net income as now determined	$13,462.61

Explanation of Adjustment

See explanation under year 1946 above.

Computation of Income Tax

Net income as now determined		$13,462.61
Less: Exemptions		2,000.00
Balance subject to tax		$11,462.61
Tentative tax on $11,462.61		$ 3,195.79
Less: 5% of $ 3,195.79		159.79
		$ 3,036.00
Less: Tax withheld from wages	$ 65.40	
Payments on Declaration of Estimated Tax	2,100.00	
Tax assessed, Original Account No. 3026541	617.89	2,783.29
Deficiency of income tax		$ 252.71

102 The Tax Court of the United States

Washington

Docket No. 41595

PHILIP J. LOBUE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

DECISION—July 9, 1954

Pursuant to the detrmination of this Court as set forth in its Opinion filed May 28, 1954 the respondent filed his compuation for entry of decision on July 8, 1954. The petitioner having noted his acquiescense therein, it is.

ORDERED AND DECIDED: That there are deficiencies in income taxes for the taxable years 1946 and 1947 in the respective amounts of $57.00 and $252.71.

STEPHEN E. RICE,
Judge.

103 United States Court of Appeals for the Third Circuit

T. C. Docket No. 41585

COMMISSIONER OF INTERNAL REVENUE, *Petitioner on Review,*

v.

PHILIP J. LOBUE, *Respondent on Review.*

PETITION FOR REVIEW

The Commissioner of Internal Revenue hereby petitions the United States Court of Appeals for the Third Circuit to review the decision entered by The Tax Court of the United States on July 9, 1954, ordering and deciding that there are deficiencies in income taxes for the taxable years 1946 and 1947 in the respective amounts of $57.00 and $252.71. The respondent on review filed his United States individual income tax returns for the calendar years 1946 and 1947 with the Collector of Internal Revenue for the Fifth District of New Jersey, located at Newark, New Jersey, and within the jurisdiction of the United States Court of Appeals

for the Third Circuit, wherein this review is sought. The Commissioner files this petition pursuant to the provisions of Sections 7482 and 7483 of the Internal Revenue Code of 1954. This controversy involves Federal income taxes for the calendar years 1946 and 1947.

H. BRIAN HOLLAND,
Assistant Attorney General
DANIEL A. TAYLOR,
Chief Counsel
Internal Revenue Service
Attorneys for Petitioner on Review

104-105 NOTICES OF FILING PETITION FOR REVIEW

(omitted in printing)

106 United States Court of Appeals for the Third Circuit

(Title Omitted)

MOTION TO ENLARGE TIME

Comes now the Commissioner of Internal Revenue, petitioner on review in the above-entitled cause, by his attorney, Daniel A. Taylor, Chief Counsel, Internal Revenue Service and moves that the time within which to file the record on review in this proceeding and to docket the cause to be extended from November 17, 1954, to and including January 6, 1955, and for cause respectfully represents:

That the question as to whether the petition for review will be further prosecuted is under consideration by the Government, that additional time is necessary in order to complete this consideration, and also if necessary to properly designate the contents of the record on review to prepare the record and to transmit it to the Court of Appeals.

WHEREFORE, it is prayed that this motion be granted.

DANIEL A. TAYLOR,
Chief Counsel
Internal Revenue Service

OF COUNSEL:

JOHN M. MORAWSKI
Special Attorney
Internal Revenue Service

107 The Tax Court of the United States

Washington

[Title omitted]

ORDER ENLARGING TIME—November 12, 1954

On motion of counsel for petitioner on review, it is

ORDERED: That the time for filing the record on appeal and docketing the appeal in the United States Court of Appeals for the Third Circuit is extended to January 6, 1955.

JOHN W. KEM,
Chief Judge.

Dated: Washington, D. C.
NOVEMBER 12, 1954.
maf

108 United States Court of Appeals for the Third Circuit

[Title omitted]

ORDER ENLARGING TIME TO FILE RECORD AND DOCKET CASE

November 20, 1954

FOR CAUSE SHOWN, IT IS ORDERED that the time within which to complete, transmit and file the record on review in the above-entitled cause to this Court, and to docket the same, be and the same is extended to and including February 21, 1955.

HERBERT F. GOODRICH,
Circuit Judge.

DECEMBER 20, 1954.

109 Clerk's Certificate to foregoing transcript omitted in printing.

110-111 MANDATE OF UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT (Omitted in printing)

112 United States Court of Appeals for the Third Circuit

T. C. Docket No. 41595

COMMISSIONER OF INTERNAL REVENUE, PETITIONER ON REVIEW

v.

PHILIP J. LOBUE, RESPONDENT ON REVIEW

MOTION TO ENLARGE TIME TO FILE RECORD AND DOCKET CASE

Comes now the Commissioner of Internal Revenue, by his counsel of record, and moves that the time within which to file the record on review and docket this proceeding in the United States Court of Appeals for the Third Circuit be extended from January 6, 1955 to and including February 21, 1955.

And for cause of this motion, petitioner on review says that he filed a petition for review with the Tax Court on October 8, 1954; that the time within which to transmit and docket the record in this Court was extended by the Tax Court to January 6, 1955; that the question as to whether the appeal will be further prosecuted is under consideration by the Government; that additional time is necessary in order to complete this consideration; and that pending final action with respect thereto it would appear undesirable and of no advantage to either party hereto to prepare and transmit to this Court the record on review herein.

WHEREFORE, it is prayed that this motion be granted.

(S.) H. BRIAN HOLLAND,
Assistant Attorney General,
(S.) R. P. HERTZOG,
Acting Chief Counsel,
Internal Revenue Service,
Counsel for Petitioner on Review.

CONSENTED TO:

(S.) RICHARD F. BARRETT,
30 Federal Street,
Boston 10, Massachusetts,
Counsel for Respondent on Review.

SO ORDERED:

____ ____,
U.S. Circuit Judge.

113 (File endorsement omitted)

United States Court of Appeals for the Third Circuit

[Title omitted]

ORDER EXTENDING TIME TO FILE RECORD AND DOCKET CASE—December 20, 1954

FOR CAUSE SHOWN, IT IS ORDERED that the time within which to complete, transmit and file the record on review in the above-entitled cause to this Court, and to docket the same, be and the same is extended to and including February 21, 1955.

HERBERT F. GOODRICH,
Circuit Judge.

DECEMBER 20, 1954.

114 (File endorsement omitted)

In the United States Court of Appeals for the Third Circuit

[Title omitted.]

MOTION OF RAYMOND G. LOCHIEL FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND ORDER GRANTING SAME—Filed March 10, 1955

RAYMOND G. LOCHIEL, by undersigned counsel, hereby moves this court for leave to file a brief amicus curiae in this case, and in support thereof shows as follows:

1. That counsel is familiar with the issue in this case and knows that it involves the question of the taxability to respondent of income arising out of his exercise of stock options granted to him by his corporate employer, and that said question is controlled by Section 39.22(a)-1(c) of Treasury Regulation 118, as amplified by Treasury Decision 5507 and Income Tax Ruling 3795.

2. That the Tax Court of the United States decided in this case that the sections of the regulations cited above were invalid and that the question of whether or not respondent realized ordinary income on his exercise of the stock options is a question of fact in each case.

3. That Raymond G. Lochiel is petitioner in Docket No. 44273 now pending in the Tax Court of the United States and that his case involves the identical legal question here involved as set forth in the preceding paragraphs.

115 4. That Mr. Lochiel is only one of twelve employees of Capital Airlines, Inc., who received options to purchase stock in that corporation pursuant to the same corporate resolu-

tion; and that the federal income tax returns of several of those optionees are being held in abeyance by various offices of the Internal Revenue Service pending the resolution of the question by this Court in his case.

5. That counsel believe that the question is of widespread importance and that its resolution would be in the public interest and in the interest of a sound tax administration; and that it would be helpful to this court to have before it a separate brief dealing solely with the legal question of the validity of the regulations.

6. That as indicated by the photostatic copies of the letters of February 11 and February 23 to Lipman Redman, Esq., one of the undersigned counsel, counsel for both petitioner and respondent have no objections to the granting of this motion.

Respectfully submitted,

CHARLES H. MURCHISON,
1016 Ring Building,
Washington 6, D. C.

LIPMAN REDMAN,
607 Ring Building,
Washington 6, D. C.,
Counsel for Movant.

Of counsel:
STOCKTON, ULMER & MURCHISON,
1016 Ring Building,
Washington 6, D. C.

Of counsel:
GUGGENHEIMER, UNTERMYER, GOODRICH AND AMRAM,
607 Ring Building,
Washington 6, D. C.

3/10/55

MOTION GRANTED.

For the Court.

MCLAUGHLIN,
J.

116-117 LETTERS CONSENTING TO FILING OF AMICUS CURIAE BRIEF
(Omitted in printing)

118 (File endorsement omitted)

United States Court of Appeals for the Third Circuit

[Title omitted]

MOTION AND ORDER ENLARGING TIME TO FILE BRIEF—March 15, 1955

Now comes Philip J. LoBue, by his counsel of record, and moves that the time within which to file his brief in the above-entitled proceeding be extended from March 22, 1955 to and including April 8, 1955.

And for cause of this motion, respondent on review says that his principal counsel in this matter, Richard F. Barrett, is seriously ill and has been confined to his home for several weeks; that no one else is sufficiently familiar with this particular case to prepare a brief within the allotted time which will adequately present such case for the respondent on review.

WHEREFORE, it is prayed that this motion be granted.

(S.) H. AVERY RAFUSE,
30 Federal Street,
Boston 10, Massachusetts,
Co-Counsel for Respondent on Review.

CONSENTED TO:
(S.) H. BRIAN HOLLAND,
Assistant Attorney General,
Internal Revenue Service,
Counsel for Petitioner on Review.

SO ORDERED:
MARIS,
U. S. Circuit Judge.
MARCH 15, 1955.

119 (File endorsement omitted)

United States Court of Appeals for the Third Circuit

[Title omitted]

MOTION AND ORDER ENLARGING TIME TO FILE BRIEF—March 30, 1955

Now comes Philip J. LoBue, by his counsel of record, and moves that the time within which to file his brief in the above-entitled

proceeding be extended from April 8, 1955 to and including April 22, 1955.

And for cause of this motion, respondent on review says that his principal counsel in this matter, Richard F. Barrett, has not recovered sufficiently from his recent illness to prepare a brief within the allotted time; that no one else is sufficiently familiar with this particular case to prepare a brief within such time which will adequately present such case for the respondent on review.

WHEREFORE, it is prayed that this motion be granted.

(S.) H. AVERY RAFUSE,
30 Federal Street,
Boston 10, Massachusetts,
Co-Counsel for Respondent on Review.

CONSENTED TO:

(S.) H. BRIAN HOLLAND,
Assistant Attorney General,
Internal Revenue Service,
Counsel for Petitioner on Review.

SO ORDERED:

MARIS,
U. S. Circuit Judge.

MARCH 30, 1955.

120 United States Court of Appeals for the Third Circuit

No. 11,524

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILIP J. LOBUE, RESPONDENT.

On Petition for Review of the Decision of the Tax Court of the United States

Argued May 3, 1955

Before MARIS and HASTE, *Circuit Judges,* and MILLER, *District Judge.*

OPINION OF THE COURT—Filed June 9, 1955

By MARIS, *Circuit Judge.*

This case involves the taxability as compensation to the taxpayer of the difference between the purchase price and market value of

stock in his employer, Michigan Chemical Corporation, which was acquired by him pursuant to stock options granted to
121 him as an employee by that corporation. The facts are set out at length in the opinion of the Tax Court in this case, 22 T.C. 440, and need not be repeated here. Suffice it to say that the Commissioner of Internal Revenue determined a deficiency in income tax against the taxpayer for the years 1946 and 1947 with respect to stock of the Michigan Chemical Corporation purchased by the taxpayer in each of those years at less than current market values pursuant to options previously given. The taxpayer petitioned the Tax Court for a redetermination of his tax liability. That court found that the options granted to the taxpayer "were to give him a proprietary interest in the corporation, and not as compensaion for services," and concluded that no taxable gain was realized by the exercise of the options. The Commissioner here asks us to reverse this decision.

A virtually unbroken line of cases supports the Tax Court in holding that if the grant of a stock option by a corporation to its employee is intended as additional compensation to him the excess of the fair market value over the option price is income taxable to him when the option is exercised, but on the other hand if the grant of the option is intended to provide him with a proprietary interest in the business no taxable gain is recognized when the option is exercised, whether the grant of the option is the one or the other being in every case a question of fact.[1]

122 The Commissioner asserts, nonetheless, that this is not the law, but that Commissioner v. Smith, 1945, 324 U. S. 177,

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[1] Durkee v. Welch, D.C.S.D. Calif. 1931, 49 F. 2d 339; Erskine v. Commissioner, 1932, 26 B.T.A. 147; Omaha Nat. Bank v. Commissioner of Internal Revenue, 8 Cir. 1935, 75 F. 2d 434; Rossheim v. Commissioner of Internal Revenue, 3 Cir. 1937, 92 F. 2d 247; Geeseman v. Commissioner, 1938, 38 B.T.A. 258; Evans v. Commissioner, 1938, 38 B.T.A. 1406; Adams v. Commissioner, 1939, 39 B.T.A. 387; Springford v. Commissioner, 1940, 41 B.T.A. 1001; Epsen v. Commissioner, 1941, 44 B.T.A. 322; Connolly's Estate v. Commissioner of Internal Revenue, 6 Cir. 1943, 135 F. 2d 64; Landen v. Commissioner, 1943, 1 TCM 411; Lamond v. Commissioner, 1946, 5 TCM 51; Nicolson v. Commissioner, 1949, 13 T.C. 690; Clark v. Commissioner, 1950, 9 TCM 719; Commissioner of Internal Revenue v. Bradner, 6 Cir. 1953, 209 F. 2d 956, affirming 11 TCM 566; McNamara v. Commissioner, 1953, 19 T.C. 1001, 1009, rev. on other grounds, 7 Cir., 210 F. 2d 505; Rosenberg v. Commissioner, 1953, 20 T.C. 5; Hazelton v. Commissioner, 1953, 12 TCM 398; Noland v. Commissioner, 1953, 12 TCM 1003; Commissioner of Internal Revenue v. Straus, 7 Cir. 1953, 208 F. 2d 325.

and section 29.22(a)-1 of Regulations 111, as amended by T.D. 5507 (1946-1 Cum. Bull. 18) following the decision in the Smith case, compel the conclusion that taxable income results whenever a stock option given by a corporation to an employee is exercised at an option price less than fair market value, the option not being a gift.

In the Smith case there was no doubt as to the stock option having been given to the employee as compensation. It was so found by the Tax Court and the finding of that court was upheld by the Supreme Court. The sole question was whether taxable income was realized at the time that the option thus given as compensation was exercised. The Supreme Court held that it was, saying (p. 181):

> "Section 22(a) of the Revenue Act is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."

It will be seen that the Smith case does not hold that the exercise of any stock option given to an employee may result in taxable gain to him when exercised even though the option was given to enable him to acquire a proprietary interest in the corporation and not as compensation.

Nonetheless the Commissioner, shortly after the decision of the Smith case, by T.D. 5507 amended the regulations so as to read:

> "If property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value *is in the nature of compensation* and shall be included in the gross income of the employee." (Emphasis supplied).

123 The amendment dropped from the regulation the former qualifying clause which read: "to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered." By I.T. 3795 (1946-1 Cum. Bull. 15) the amendment made by T.D. 5507 was held to be applicable to stock options granted by corporations to their employees on and after February 26, 1945, the date of the Supreme Court's decision in the Smith case.

While the Commissioner has heretofore stated that this change in his regulations was based upon the decision in the Smith case he now abandons that position and asserts that the amendment does not go beyond the scope of section 22(a) of the Internal Reve-

nue Code of 1939 and is, therefore, valid and binding as eliminating any middle non-taxable ground in these cases between a pure gift on the one hand and an economic benefit which must be treated taxwise as compensation on the other. We agree with the Commissioner that the decision in the Smith case does not support the amendment made by T. D. 5507 even though it was the ostensible basis for it. But we cannot agree that section 22(a) supports the amendment in compelling any economic benefit derived by a corporation's employee from the exercise of a stock option to be treated as compensation and taxable as such regardless of whether or not it was so intended.

Section 29.22(a)-1 of the regulations as it stood before the amendment [2] was itself a recognition by the Commissioner when he adopted it in 1939 that section 22(a) of the Internal Revenue Code did not include in gross income for purposes of income tax the entire economic benefit received by a corporation's employee upon every purchase of stock for less than its fair market value, but only to the extent that such benefit was in the nature of compensation. In so providing the Commissioner abandoned a regulation, [3] similar to his present one, thereby acceding to judicial authority
124 which refused to uphold that position. [4] The regulation thus adopted in 1939 in response to the rulings of the courts has itself been applied with approval [5] and we think that it, and not the amendment effected in 1946 by T.D. 5507, conformed to section 22(a) of the Code.

It is denying the facts of economic life to assert that every grant of a stock option to a corporation's employee is necessarily additional compensation to the extent that at the time of exercise the market value of the stock exceeds the option price. For it is a well known and common practice of American business corporations to seek to retain the continued interest in the business of their key employees by inducing them through favorable stock options to ac-

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[2] T.D. 4879, 1939-1 Cum. Bull. 159.

[3] T.D. 3435, II-1 Cum. Bull. 50 (1923).

[4] Taplin v. Commissioner of Internal Revenue, 6 Cir. 1930, 41 F. 2d 454; Commissioner of Internal Revenue v. Van Vorst, 9 Cir. 1932, 59 F. 2d 677; Rossheim v. Commissioner of Internal Revenue, 3 Cir. 1937, 92 F. 2d 247; Geeseman v. Commissioner, 1938, 38 B.T.A. 258; Evans v. Commissioner, 1938, 38 B.T.A. 1406; Adams v. Commissioner, 1939, 39 B.T.A. 387; Springford v. Commissioner, 1940, 41 B.T.A. 1001; Hawke v. Commissioner, 9 Cir. 1940, 109 F. 2d 946, cert. den. 311 U.S. 657.

[5] Commissioner of Internal Revenue v. Straus, 7 Cir. 1953, 208 F. 2d 325.

quire a proprietary interest as stockholders. In a great many such cases the immediate economic benefit to the employee is minor, incidental and, often, quite fortuitous. Such transactions are, however, not gifts for there is a very real consideration to the corporation, the continued interest of a key employee. There are, of course, other cases in which the element of compensation is the important one. But the fact that there is an element of immediate economic benefit does not exclude the conclusion that the option was given solely to provide the employee with a proprietary interest and that the immediate benefit was purely incidental and not compensatory.

We are in accord with the statement by Judge Turner in his opinion in Geeseman v. Commissioner, 38 B.T.A. 258, 263-264, in which the Commissioner acquiesced (1939-1 Cum. Bull. 13), that:

> "To hold that a transaction of the character here involved is a 'bargain' purchase having nothing to do with the employer-employee relationship, or, to the contrary, that it is not a purchase but constitutes the receipt of compensation having nothing to do with the purchase of property, to the extent that the fair market value exceeds the purchase price, is to ignore obvious facts and to assume a case substantially different from the one before us. In the first place, it may not be said that the acquisition of the stock of Continental Can Co. was not a purchase merely because the price paid was substantially lower than the price at which the same stock was then selling on the market and, in the second place, obvious facts are ignored if it be said that the stock transaction was separate and apart from, or was not based upon, the employer-employee relationship, or that it had no relation to services rendered or to be rendered. In practically all such cases both elements are present and decision is impossible if the absence of one or the other is essential thereto.
>
> "Normally the puchase of property does not result in the realization of taxable gain, but rather in the acquisition of an asset with a view to the later realization of gain or profit through its use or subsequent sale, and upon sale the general rule is that no taxable gain is realized until the seller has recovered his cost or capital. . . . Accordingly it is our opinion that as a prerequisite to the conclusion sought by the respondent it should definitely and clearly appear that a transaction, which in form is nothing more than a purchase and to an obvious and substantial extent is unquestionably a purchase, is in fact to some extent the payment of compensation for services rendered or to be rendered."

In the present case, as we have said, the Tax Court found as a fact that the options granted to the taxpayer by the Michigan Chemical Corporation "were to give him a proprietary interest in the corporation, and not as compensation for services." This
126 was a factual issue which it was the peculiar responsibility of the Tax Court to resolve. From our examination of the evidence we cannot say that its finding was clearly erroneous.

The decision of the Tax Court will be affirmed.

127 United States Court of Appeals for the Third Circuit

No. 11,524

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

PHILIP J. LOBUE, RESPONDENT

JUDGMENT—June 9, 1955

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

Attest:

IDA O. CRESKOFF,
Clerk.

JUNE 9, 1955.

Received & Filed. Jun 9, 1955. Ida O. Creskoff, Clerk.

128 MANDATE (Omitted in printing)

129 Clerk's Certificate to foregoing transcript omitted in printing.

130 Supreme Court of the United States

ORDER ALLOWING CERTIORARI.—Filed November 14, 1955

The petition herein for a writ of certiorari to the United States Court of Appeals for the Third Circuit is granted, and the case is transferred to the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1955 326188 695

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SEP 2 1955
HAROLD B. WILLEY, Clerk

No. — 373

In the Supreme Court of the United States

OCTOBER TERM, 1955

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILIP J. LOBUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

SIMON E. SOBELOFF,
Solicitor General,
H. BRIAN HOLLAND,
Assistant Attorney General,
ELLIS N. SLACK,
HILBERT P. ZARKY,
JOSEPH F. GOETTEN,
Attorneys,
Department of Justice,
Washington 25, D. C.

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In the Supreme Court of the United States

OCTOBER TERM, 1955

No. —

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILIP J. LOBUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment entered in this case by the United States Court of Appeals for the Third Circuit.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 51a-59a) are reported at 22 T. C. 440. The opinion of the Court of Appeals, which has not yet been officially reported, appears in the Appendix, *infra*, pp. 21-29.

JURISDICTION

The judgment of the Court of Appeals (Appendix, *infra*, pp. 29-30) was entered on June 9, 1955. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Where an employee is permitted to buy stock in his employer corporation at a price less than fair market value, is the resulting gain to the employee to be excluded from taxable income simply because the employer intended him to acquire a proprietary interest in its business?

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 22.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.22(a)-1. *What Included in Gross Income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. * * *

If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. * * *

* * * * *

SEC. 29.22 (a)-1 [As amended by T. D. 5507, 1946-1 Cum. Bull. 18]. *What Included in Gross Income.*—Gross income includes in general compensation for personal and profes-

sional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. * * *

* * * * *

If property is transferred by a corporation to a shareholder, for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, such shareholder shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of a distribution of earnings or profits taxable as a dividend. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. * * *

If property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value is in the nature of compensation and shall be included in the gross income of the employee. * * *

* * * * *

STATEMENT

From September, 1941, to February 28, 1947, the taxpayer was employed as manager of the New York sales division of the Michigan Chemical Corporation. There was no written contract covering the terms and conditions of his employment. The nature and extent of his duties remained the same throughout this period. He received a salary of $6,000 per annum in 1944 and 1945, and of $6,600 per annum in 1946 and 1947. (R. 51a.)

A plan to issue employee stock options had been approved at a meeting of Michigan Chemical Corporation's stockholders on March 21, 1944. Under the plan 10,000 shares of the corporation's common stock were to be made available to certain key employees of the corporation over the ensuing three years. At that time the fair market value of the stock was $4.50 a share and the option price was fixed at $5 a share. (R. 51a-52a.)

By a letter from the executive vice president of the corporation dated June 29, 1944, the taxpayer was informed of the terms and conditions of the employee stock option plan and of its purpose to provide an incentive to key employees and to permit them to participate in the success of the corporation. The taxpayer was congratulated on having been included in the list of those selected as competent to perform outstanding service and thereby participate in the future of the corporation. He

was advised that the allotment of stock to key men would be based on results accomplished and that monthly figures during the year would show the results of his efforts. Basic factors which should directly affect his accomplishments were enumerated and it was suggested that he select those areas in which he could make the greatest contribution. (R. 20a-22a.)

The taxpayer was granted the first non-transferable option covering 150 shares at $5 a share by letter from the executive vice president dated January 18, 1945. The fair market value of the stock in January, 1945, was $8.69 a share. (R. 54a.) The option could be exercised on June 30 of that year if the recipient was then still employed by the corporation. The taxpayer was advised that the allotment of 150 shares to him was in recognition of his contribution and efforts in making the operation of the corporation successful. He was told that further allotments would be recommended in accordance with the plan and that it was up to him to justify his participation in the plan during the next two years. (R. 23a-24a.)

The taxpayer was granted the second option to purchase under similar conditions an additional 150 shares at $5 a share by a letter from the executive vice president dated January 1, 1946. The fair market value of the stock in January, 1946, was $19.25 a share. (R. 54a.) The taxpayer was reminded that the extent of his participation in the plan was based on how well he handled his job during the year and that outstanding service to the

corporation was given added recognition in determining the number of shares assigned. He was told that it was only natural to expect a more rigid comparative appraisal of his efforts in the future; that any company was dependent upon its management and personnel for such success as might accrue to it; and that he was expected to contribute his share to the corporation's success. (R. 25a-26a.)

In 1946, upon exercise of the two employee stock options, the taxpayer received 300 shares of the corporation's stock for $8,100 less than its fair market value at that time. (R. 53a, 55a.)

The taxpayer was granted the third option to purchase an additional 40 shares under similar conditions by a letter from the president of the corporation dated January 2, 1947. The taxpayer was again advised that allocations, as in previous years, had been determined after a careful appraisal of the employee's contribution to the corporation's progress during the past year. The president congratulated the taxpayer on having earned this recognition given to him and expressed the trust that the taxpayer's future services, suggestions and interest in the corporation's welfare would warrant even greater recognition. (R. 26a-28a.)

In February, 1947, the taxpayer exercised this option and received an additional 40 shares of the corporation's stock for $580 less than its fair market value at that time. (R. 54a, 55a.)

In its income tax returns for 1946 and 1947, but not in 1945, the corporation deducted the amount of the difference between the option price at which

it sold stock to key employees during those years and the fair market value of that stock at such times. (R. 54a.)

The taxpayer's returns having failed to reflect his receipt or exercise of the employee stock options, the Commissioner issued a deficiency notice in which he determined that, when the taxpayer in 1946 and 1947 received his employer-corporation's stock for less than its fair market value through exercise of the employee stock options, the taxpayer realized taxable income in the nature of additional compensation in the amounts of $8,100 and $580, respectively. (R. 55a.) A petition for redetermination having been filed, the Tax Court entered a decision in favor of the taxpayer, concluding that the options had been granted to him not as additional compensation but to give him a proprietary interest in the corporation, and holding invalid Section 29.22(a)-1 of Treasury Regulations 111, as amended by T.D. 5507, 1946-1 Cum. Bull. 18, upon which the Commissioner relied. (R. 55a-59a, 60a.)

Agreeing that the Treasury regulation was invalid, the Third Circuit affirmed the Tax Court's decision. In reaching its conclusion, the Third Circuit reasoned (Appendix, *infra*, pp. 26-27) that, notwithstanding the broad definition of gross income contained in Section 22(a) of the Internal Revenue Code of 1939, a taxpayer upon exercise of an employee stock option could receive an immediate economic benefit which, although not a gift, would not constitute taxable income but would be

considered merely "incidental" if the intent of the employer-corporation in issuing the option was to have the taxpayer acquire a proprietary interest.

REASONS FOR GRANTING THE WRIT

This case presents an important question which should be decided by this Court, namely, whether a taxpayer's gain on acquisition of his employer corporation's stock for substantially less than its fair market value through the exercise of employee stock options, where it is found not to be a gift, constitutes taxable income. The question is of special importance and the decision of the Court of Appeals conflicts in principle with decisions of this Court, for the following reasons:

1. The granting of stock options as a means of conferring additional economic gain on corporate employees, particularly executives and other key officials, has become increasingly widespread in recent years. In no small part, the popularity of this corporate practice is attributable to decisions which, like that of the Court of Appeals in the instant case, permit the favored corporate official to receive this economic gain free of the same kind of tax burden borne by employees who receive their compensation in other forms. The tax-avoidance advantages of using employee stock options as an avenue by which ordinary income may take the attractive capital gain by-pass, thus enabling corporate executives to receive more take-home pay, have been widely publicized. The serious consequences to the revenue are obvious.

Recent surveys reveal that since 1950 approximately one out of every three sizeable companies having securities listed on the New York Stock Exchange has offered stock option plans to employees and that the use of such plans is still spreading. Stryker, Do Stock Options Pay, Fortune, December 1954, p. 118; Option Opulence, Wall Street Journal, February 1, 1955, p. 1. And, although actual statistics are not available, the practice among smaller corporations, such as the taxpayer in the instant case, which do not have securities listed on national stock exchanges appears to be equally widespread. Recent legal and trade periodicals contain numerous articles dealing with employee stock options.[1] In this modern alchemy of trans-

[1] These articles include: Miller, Capital Gains Taxation Of The Fruits Of Personal Effort: Before And Under The 1954 Code, 64 Yale L. J. 1 (Nov. 1954); McCarthy, A Survey Of Types Of Supplementary Compensation For Executives, 30 Taxes 878 (Nov. 1952); Lasser, How To Raise The Take-Home Pay Of High-Priced Help Under Today's Wage Freeze and Tax Laws, 93 Journal Of Accountancy 166 (Feb. 1952); Mahon, Corporate Tax Planning To Get Minimum Personal Tax Liability For Executives And Stockholders, 92 Journal of Accountancy 582 (Nov. 1951); Stryker, How Much Is An Executive Worth, Fortune, April 1955, p. 108; Bock, Tax-saving Opportunities In Deferred Compensation Under The New Revenue Code, 99 Journal of Accountancy 39 (March 1955); Garfinkle, Stock Option Plans For Executives, 41 Calif. L. Rev. 535 (Fall 1953); Gardner, Employee Stock Options, 50 Mich. L. Rev. 409 (Jan. 1952); Tarleau, The Problem Of Compensating Executives, Proceedings of Tax. Institute of So. Calif. School of Law, p. 149 (1953); Lentz, Stock Ownership Plans—Options, Warrants, Leverage Stock, Thirteenth Annual N. Y. U. Institute On Federal Taxation, p. 499 (1955); Lyon, Capital Gains Benefits Connected With Executive Retirement, Twelfth Annual N. Y. U. Institute on Federal Tax-

forming ordinary income into capital gains, one writer has enumerated 38 features which should be avoided in connection with employee stock option plans lest such options be classified as compensatory. Sax, Stock Options, 23 Taxes 505 (1945).

The facts of this case, then, do not represent an isolated factual situation. Nor is this an isolated decision. The Tax Court, where many of these cases originate, has taken the same position,[2] as have other Courts of Appeals in connection with a prior Treasury regulation.[3] Review by this Court is essential to bring the resolution of this issue into harmony with prior decisions of this Court and to

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ation, p. 365 (1954); Ivins, What Is New In Employee Stock Options, Tenth Annual N. Y. U. Institute on Federal Taxation, p. 121 (1952); Rudick, Compensation Of Executives Under the 1954 Code, 33 Taxes 7 (Jan. 1955); Leake, Compensating Executives And The Latest In Stock Options, 32 Taxes 488 (June 1954); Rice, Incentives For Executives of Small Corporations, 32 Taxes 222 (March 1954); Lyon, Employee Stock Purchase Arrangements, 31 Taxes 1021 (Dec. 1953); Landman, Executive Stock Options, 31 Taxes 735 (Sept. 1953); Lloyd, Relations Between The Corporation And Its Officers And Employees, 30 Taxes 546 (July 1952); Light, The Taxation Of Unrestricted Stock Options, 23 G.W. L. Rev. 329 (Jan. 1955); Taxation Of Compensatory Stock Options: Capital Gain Or Ordinary Income, 64 Yale L. J. 269 (Dec. 1954); Mann, Deferred Compensation And Stock Option Plans May Be Legal, But Are They Ethical, 93 Journal of Accountancy 324 (March 1952); Boland, Employee Options Under the Federal Income Tax, 28 Taxes 415 (May 1950).

[2] See, for example, *Bowen* v. *Commissioner*, decided July 22, 1954 (1954 P-H T.C. Memorandum Decisions, par. 54,207).

[3] See, for example, *Commissioner* v. *Straus*, 208 F. 2d 325 (C.A. 7th); *Commissioner* v. *Bradner*, 209 F. 2d 956 (C.A. 6th).

preserve the Congressional pattern for the taxation of income received by employees from stock option plans.

2. The decision below holds invalid Section 29.22 (a)-1 of Treasury Regulations 111, as amended by T.D. 5507, 1946-1 Cum. Bull. 18, *supra*, pp. 3-4. In so holding the Third Circuit has ruled that the definition of gross income contained in Section 22(a) of the Internal Revenue Code of 1939, *supra*, p. 2 (Sec. 61 of the Internal Revenue Code of 1954), is not broad enough to support a Treasury regulation requiring a taxpayer to report as taxable income the gain which he realizes when his employer transfers valuable property to him, otherwise than by gift, for less than its fair market value. The decision conflicts in principle with this Court's holding that in defining gross income it was "the intention of Congress to tax all gains except those specifically exempted." *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 430. See *Rutkin* v. *United States*, 343 U.S. 130, 139; *Commissioner* v. *Jacobson*, 336 U.S. 28, 49; *Helvering* v. *Bruun*, 309 U.S. 461, 468; *Helvering* v. *Clifford*, 309 U.S. 331, 334; *Douglas* v. *Willcuts*, 296 U.S. 1, 9; *Irwin* v. *Gavit*, 268 U.S. 161, 166; *Robertson* v. *United States*, 343 U.S. 711.

The Regulation in question represents long and studied efforts by the Treasury Department to state a rule which, in harmony with the broad Congressional purpose embodied in Section 22 (a) of the statute, will tax the employee with ordinary income when he realizes a gain conferred on him by

his corporate employer. Under the uniform rulings of this Court, such Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the statute which they interpret; they are not to be overruled except for weighty reasons. *Lykes* v. *United States*, 343 U.S. 118; *Commissioner* v. *South Texas Co.*, 333 U.S. 496; *Commissioner* v. *Wheeler*, 324 U.S. 542; *Helvering* v. *Wilshire Oil Co.*, 308 U.S. 90; *Fawcus Machine Co.* v. *United States*, 282 U.S. 375; *Brewster* v. *Gage*, 280 U.S. 327; *Boske* v. *Comingore*, 177 U.S. 459.

The holding of the court below which invalidates this Treasury regulation is out of harmony with the decisions of this Court and raises questions of manifest importance to the revenue.

3. The Court of Appeals and the Tax Court have adopted an illogical, artificial test for determining when an employee receives taxable income upon exercise of an employee stock option. Thus, although recognizing that on exercise of such an option an employee receives an immediate economic benefit which is not a gift, the Court of Appeals nevertheless holds (*infra*, pp. 26-27) that that economic benefit does not constitute taxable income if the intent of the employer-corporation in issuing the option was that the employee acquire a proprietary interest.

Since, as the court below recognized, the employee received an immediate economic gain upon the exercise of the stock options and since, as the court below also recognized, the gain did not represent a gift or come within any other category of

income specifically exempted by Congress from taxation or specifically entitled to be taxed at different rates or at a different point of time, the conclusion seems inevitable that the gain realized by the employee falls within the broad sweep of Code Section 22 (a). *Commissioner* v. *Glenshaw Glass Co.*, 348 U. S. 426.

This realization of economic gain does not fall outside the scope of Section 22 (a) simply because, as described by the court below, it was received by the employee as a consequence of the employer's motive to enable the employee (Appendix, *infra*, p. 24) "to acquire a proprietary interest" as a stockholder. In the first place, the statute contains no justification for using such a motive as a reason for exempting the resulting gain from the broad coverage of Section 22 (a) or for granting preferential tax results to employees so situated. Secondly, there is no inconsistency between the employee's acquiring a proprietary interest and at the same time receiving taxable gain from the exercise of the stock option. Compensation to an employee can take the form of a grant of a proprietary interest. The latter does not negate the former. A corporation must necessarily intend any person to whom it sells its stock, by option or otherwise, to acquire a proprietary interest. In the case of employee stock options, where the acquisition of the stock interest is at a price less than that at which the corporation is willing to sell the stock to others, the employee obviously realizes a gain which is not available to others. However

sincerely the corporate employer hopes to benefit from its employees' acquisition of a proprietary interest in it, the incentive it offers its employees takes the form of economic gain. Since such offers are generally, and in the present case specifically, related to the services of the employees both past and future, the gain has all the indicia of compensation; and hence, unless it be found to be a gift, should be taxable as income. Cf. *Van Dusen* v. *Commissioner*, 166 F. 2d 647 (C.A. 9th). In a case like this, the simple fact is that the employees have received an immediate gain of measurable value. Therefore, unless it is shown to have the elements of a gift, the Regulations treating this gain as taxable income under Section 22(a) of the Internal Revenue Code are entirely proper, and their validity should be sustained.

4. The decision of the Court of Appeals, if its rationale is correct, will frustrate the purpose of Congress in enacting the restricted stock option provisions contained in Section 130A of the Internal Revenue Code of 1939, as added by Section 218 of the Revenue Act of 1950, c. 994, 64 Stat. 906, now reenacted as Section 421 of the Internal Revenue Code of 1954. When Congress enacted those restricted stock option provisions, it sought to give preferential tax treatment to employee stock options meeting certain prescribed qualifications and safeguards. See S. Rep. No. 2375, 81st Cong., 2d Sess., pp. 59-60 (1950-2 Cum. Bull. 483, 526). Under those provisions the tax on the gain realized by an employee when he acquires his employer cor-

poration's stock for less than its fair market value through the exercise of a restricted employee stock option is postponed until the employee sells the stock. At such time his gain [4] is taxed as ordinary income unless the option price was 95% or more of the fair market value of the stock when the option was issued. It will be noted that, even in the precise area where Congress has provided this carefully limited special treatment for employee stock options, the employer's intent to grant a "proprietary interest" is not a relevant factor in determining tax consequences.

The "proprietary interest" test, used by the Court of Appeals to justify its conclusion that no income is realized, is broad enough to defeat the Congressional purpose of granting some special tax benefits only where the prescribed conditions have been met. That is, if the Court of Appeals is correct in its conclusion that the economic gain conferred on the employee is not embraced by the all-inclusive definition of income contained in Section 22(a) where the motive is one of granting a proprietary interest, there will be no need for complying with the statutory safeguards in any other situation where a similar motive exists. And the vice of the decision below goes further—unlike the statutory provisions dealing with stock options which insure that the employee will eventually be

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[4] The amount of gain taxable as ordinary income is the difference between the option price and the fair market value of the stock when the option is granted or when the stock is disposed of, whichever is less.

taxed with *ordinary income* (except where the initial spread is less than five per cent), the decision of the Court of Appeals not only postpones the tax until the stock is sold, but has the effect of taxing the entire gain at that point as *capital gain* at preferential rates and of freeing his gain from any income tax whatsoever if the taxpayer dies without having sold the stock. In this respect, too, the decision below raises an important issue which should be settled by this Court.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted,

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SEPTEMBER, 1955.

APPENDIX

UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

No. 11,524

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILIP J. LOBUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

Argued May 3, 1955

Before Maris and Hastie, Circuit Judges, and Miller, District Judge

OPINION OF THE COURT—Filed June 9, 1955

By MARIS, *Circuit Judge:*

This case involves the taxability as compensation to the taxpayer of the difference between the purchase price and market value of stock in his employer, Michigan Chemical Corporation, which was acquired by him pursuant to stock options granted to him as an employee by that corporation. The facts are set out at length in the opinion of the Tax Court in this case, 22 T. C. 440, and need not be repeated here. Suffice it to say that the Commissioner of Internal Revenue determined a deficiency in income tax against the taxpayer for the years 1946 and 1947 with respect to stock of the

Michigan Chemical Corporation purchased by the taxpayer in each of those years at less than current market values pursuant to options previously given. The taxpayer petitioned the Tax Court for a redetermination of his tax liability. That court found that the options granted to the taxpayer "were to give him a proprietary interest in the corporation, and not as compensation for services," and concluded that no taxable gain was realized by the exercise of the options. The Commissioner here asks us to reverse this decision.

A virtually unbroken line of cases supports the Tax Court in holding that if the grant of a stock option by a corporation to its employee is intended as additional compensation to him the excess of the fair market value over the option price is income taxable to him when the option is exercised, but on the other hand if the grant of the option is intended to provide him with a proprietary interest in the business no taxable gain is recognized when the option is exercised, whether the grant of the option is the one or the other being in every case a question of fact.[1]

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[1] Durkee v. Welch, D.C.S.D. Calif. 1931, 49 F. 2d 339; Erksine v. Commissioner, 1932, 26 B.T.A. 147; Omaha Nat. Bank v. Commissioner of Internal Revenue, 8 Cir. 1935, 75 F. 2d 434; Rossheim v. Commissioner of Internal Revenue, 3 Cir. 1937, 92 F. 2d 247; Geeseman v. Commissioner, 1938, 38 B.T.A. 258; Evans v. Commissioner, 1938, 38 B.T.A. 1406; Adams v. Commissioner, 1939, 39 B.T.A. 387; Springford v. Commissioner, 1940, 41 B.T.A. 1001; Epsen v. Commissioner, 1941, 44 B.T.A. 322; Connolly's Estate v. Commissioner of Internal Revenue, 6 Cir. 1943, 135 F. 2d 64; Landen v. Commissioner, 1943, 1 TCM 411; Lamond v. Commissioner, 1946, 5 TCM 51; Nicolson v. Commissioner, 1949, 13 T.C. 690;

The Commissioner asserts, nonetheless, that this is not the law, but that Commissioner v. Smith, 1945, 324 U.S. 177, and section 29.22(a)-1 of Regulations 111, as amended by T.D. 5507 (1946-1 Cum. Bull. 18) following the decision in the Smith case, compel the conclusion that taxable income results whenever a stock option given by a corporation to an employee is exercised at an option price less than fair market value, the option not being a gift.

In the Smith case there was no doubt as to the stock option having been given to the employee as compensation. It was so found by the Tax Court and the finding of that court was upheld by the Supreme Court. The sole question was whether taxable income was realized at the time that the option thus given as compensation was exercised. The Supreme Court held that it was, saying (p. 181):

> "Section 22(a) of the Revenue Act is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."

It will be seen that the Smith case does not hold that the exercise of any stock option given to an

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Clark v. Commissioner, 1950, 9 TCM 719; Commissioner of Internal Revenue v. Bradner, 6 Cir. 1953, 209 F. 2d 956, affirming 11 TCM 566; McNamara v. Commissioner, 1953, 19 T.C. 1001, 1009, rev. on other grounds, 7 Cir., 210 F. 2d 505; Rosenberg v. Commissioner, 1953, 20 T.C. 5; Hazelton v. Commissioner, 1953, 12 TCM 398; Noland v. Commissioner, 1953, 12 TCM 1003; Commissioner of Internal Revenue v. Straus, 7 Cir. 1953, 208 F. 2d 325.

employee may result in taxable gain to him when exercised even though the option was given to enable him to acquire a proprietary interest in the corporation and not as compensation.

Nonetheless the Commissioner, shortly after the decision of the Smith case, by T.D. 5507 amended the regulations so as to read:

> "If property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value *is in the nature of compensation* and shall be included in the gross income of the employee." (Emphasis supplied).

The amendment dropped from the regulation the former qualifying clause which read: "to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered." By I.T. 3795 (1946-1 Cum. Bull. 15) the amendment made by T.D. 5507 was held to be applicable to stock options granted by corporations to their employees on and after February 26, 1945, the date of the Supreme Court's decision in the Smith case.

While the Commissioner has heretofore stated that this change in his regulations was based upon the decision in the Smith case he now abandons that position and asserts that the amendment does not go beyond the scope of section 22(a) of the

Internal Revenue Code of 1939 and is, therefore, valid and binding as eliminating any middle nontaxable ground in these cases between a pure gift on the one hand and an economic benefit which must be treated taxwise as compensation on the other. We agree with the Commissioner that the decision in the Smith case does not support the amendment made by T.D. 5507 even though it was the ostensible basis for it. But we cannot agree that section 22(a) supports the amendment in compelling any economic benefit derived by a corporation's employee from the exercise of a stock option to be treated as compensation and taxable as such regardless of whether or not it was so intended.

Section 29.22(a)-1 of the regulations as it stood before the amendment [2] was itself a recognition by the Commissioner when he adopted it in 1939 that section 22(a) of the Internal Revenue Code did not include in gross income for purposes of income tax the entire economic benefit received by a corporation's employee upon every purchase of stock for less than its fair market value, but only to the extent that such benefit was in the nature of compensation. In so providing the Commissioner abandoned a regulation,[3] similar to his present one, thereby acceding to judicial authority which refused to uphold that position.[4] The regulation

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[2] T.D. 4879, 1939-1 Cum. Bull. 159.

[3] T.D. 3435, II-1 Cum. Bull. 50 (1923).

[4] Taplin v. Commissioner of Internal Revenue, 6 Cir. 1930, 41 F. 2d 454; Commissioner of Internal Revenue v. Van Vorst,

thus adopted in 1939 in response to the rulings of the courts has itself been applied with approval [5] and we think that it, and not the amendment effected in 1946 by T.D. 5507, conformed to section 22(a) of the Code.

It is denying the facts of economic life to assert that every grant of a stock option to a corporation's employee is necessarily additional compensation to the extent that at the time of exercise the market value of the stock exceeds the option price. For it is a well known and common practice of American business corporations to seek to retain the continued interest in the business of their key employees by inducing them through favorable stock options to acquire a proprietary interest as stockholders. In a great many such cases the immediate economic benefit to the employee is minor, incidental and, often, quite fortuitous. Such transactions are, however, not gifts for there is a very real consideration to the corporation, the continued interest of a key employee. There are, of course, other cases in which the element of compensation is the important one. But the fact that there is an ele-

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9 Cir. 1932, 59 F. 2d 677; Rossheim v. Commissioner of Internal Revenue, 3 Cir. 1937, 92 F. 2d 247; Geeseman v. Commissioner, 1938, 38 B.T.A. 258; Evans v. Commissioner, 1938, 38 B.T.A. 1406; Adams v. Commissioner, 1939, 39 B.T.A. 387; Springford v. Commissioner, 1940, 41 B.T.A. 1001; Hawke v. Commissioner, 9 Cir. 1940, 109 F. 2d 946, cert. den. 311 U.S. 657.

[5] Commissioner of Internal Revenue v. Straus, 7 Cir. 1953, 208 F. 2d 325.

ment of immediate economic benefit does not exclude the conclusion that the option was given solely to provide the employee with a proprietary interest and that the immediate benefit was purely incidental and not compensatory.

We are in accord with the statement by Judge Turner in his opinion in Geeseman v. Commissioner, 38 B.T.A. 258, 263-264, in which the Commissioner acquiesced (1939-1 Cum. Bull. 13), that:

> "To hold that a transaction of the character here involved is a 'bargain' purchase having nothing to do with the employer-employee relationship, or, to the contrary, that it is not a purchase but constitutes the receipt of compensation having nothing to do with the purchase of property, to the extent that the fair market value exceeds the purchase price, is to ignore obvious facts and to assume a case substantially different from the one before us. In the first place, it may not be said that the acquisition of the stock of Continental Can Co. was not a purchase merely because the price paid was substantially lower than the price at which the same stock was then selling on the market, and, in the second place, obvious facts are ignored if it be said that the stock transaction was separate and apart from, or was not based upon, the employer-employee relationship, or that it had no relation to services rendered or to be rendered. In practically

all such cases both elements are present and decision is impossible if the absence of one or the other is essential thereto.

"Normally the purchase of property does not result in the realization of taxable gain, but rather in the acquisition of an asset with a view to the later realization of gain or profit through its use or subsequent sale, and upon sale the general rule is that no taxable gain is realized until the seller has recovered his cost or capital. . . . Accordingly it is our opinion that as a prerequisite to the conclusion sought by the respondent it should definitely and clearly appear that a transaction, which in form is nothing more than a purchase and to an obvious and substantial extent is unquestionably a purchase, is in fact to some extent the payment of compensation for services rendered or to be rendered."

In the present case, as we have said, the Tax Court found as a fact that the options granted to the taxpayer by the Michigan Chemical Corporation "were to give him a proprietary interest in the corporation, and not as compensation for services." This was a factual issue which it was the peculiar responsibility of the Tax Court to resolve. From our examination of the evidence we cannot say that its finding was clearly erroneous.

The decision of the Tax Court will be affirmed.

A true Copy:

Teste:

_____,

Clerk of the United States
Court of Appeals
for the Third Circuit.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 11,524

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

PHILIP J. LOBUE, RESPONDENT

On Petition to Review a Decision of the Tax Court of the United States

Present: MARIS and HASTIE, Circuit Judges, and MILLER, District Judge.

JUDGMENT

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the de-

cision of the said Tax Court in this cause be, and the same is hereby affirmed.

Attest:
IDA O. CRESKOFF,
Clerk.

June 9, 1955.

Received & Filed June 9, 1955.
IDA O. CRESKOFF,
Clerk.

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No. 373

In the Supreme Court of the United States

OCTOBER TERM, 1955

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILIP J. LOBUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE PETITIONER

SIMON E. SOBELOFF,
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In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 373

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILIP J. LOBUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 142-149) are reported at 22 T.C. 440. The opinion of the Court of Appeals (R. 159-164) is reported at 223 F. 2d 367.

JURISDICTION

The judgment of the Court of Appeals was entered on June 9, 1955. (R. 164.) The petition for a writ of certiorari filed on September 2, 1955, was granted on November 14, 1955. (R. 164.) The jurisdiction of this Court rests upon 28 U.S.C., Section 1254.

QUESTION PRESENTED

When an employee is permitted to buy stock in his employer corporation at a price less than fair market value, and where no gift is involved, is the resulting gain to the employee to be excluded from his taxable income simply because the employer intended him to acquire a proprietary interest in its business?

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(b) Exclusions from Gross Income.—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * * * *

(3) [As amended by Sec. 111(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] Gifts, bequests, devises, and inheritances,—The value of property acquired by gift, bequest, devise, or inheritance. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.22(a)-1. *What Included in Gross Income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. * * *

If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be. In computing the gain or loss from the

subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. * * *

* * * * *

Sec. 29.22(a)-1 [As amended by T.D. 5507, 1946-1 Cum. Bull. 18]. *What Included in Gross Income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. * * *

* * * * *

If property is transferred by a corporation to a shareholder, for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, such shareholder shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of a distribution of earnings or profits taxable as a dividend. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. * * *

If property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value is in the nature of compensation and shall be included in the gross income of the employee. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income.

* * * * *

STATEMENT

From September 1941, to February 28, 1947, the taxpayer was employed as manager of the New York sales division of the Michigan Chemical Corporation. There was no written contract covering the terms and conditions of his employment. The nature and extent of his duties remained the same throughout this period. He received a salary of $6,000 per annum in 1944 and 1945, and of $6,600 per annum in 1946 and 1947. (R. 143.)

Michigan Chemical Corporation was engaged in the business of producing and selling chemical products. The company's chief executive officer, one T. C. Davis, because of his long-standing belief that both the company and its employees profited from employee stock ownership, felt that the corporation should provide some means by which its

employees could acquire a proprietary interest in the business. Mr. Davis discussed his ideas with the directors and officers of the corporation, and, at a stockholder's meeting on March 21, 1944, proposed that key employees be given an option to purchase stock. On that date the stockholders approved a plan of the board of directors whereby 10,000 shares of the corporation's common stock would be made available through options to certain key employees of the corporation over the ensuing three years. At that time the fair market value of the stock was $4.50 a share and the option price was fixed at $5 a share.[1] (R. 143.)

By a letter from Mr. Davis dated June 29, 1944, the taxpayer was informed of the terms and conditions of the employee stock option plan and of its purpose to provide an incentive to key employees and to permit them to participate in the success of the corporation. The taxpayer was congratulated on having been included in the list of those selected as competent to perform outstanding service and thereby participate in the future of the corporation. He was advised that the allotment of stock to key men would be based on results accomplished and that monthly figures during the year would show the results of his efforts. Basic factors which should directly affect his accomplish-

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[1] The corporation's application to sell 5,000 shares to T. C. Davis and 10,000 shares to key employees designated by the board of directors was approved by the Corporation and Securities Commission of the State of Michigan on June 15, 1945. (R. 23-24.)

ments were enumerated, and it was suggested that he select those areas in which he could make the greatest contribution.[2] (R.17-18.)

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[2] Following is the full text of the letter of June 29, 1944 (R. 17-18);

June 29, 1944.

Mr. Philip J. LoBue
Palisades Park, N. J.

Dear Phil:

As you know, the stockholders of your company at their meeting in March, 1944, set aside ten thousand shares of the common stock of Michigan Chemical Corporation for allotment to key employees, under a purchase plan at the price of $5.00 per share. The purpose of this is to provide an incentive to key employees and especially to permit such men to participate in the success of the Company. This is a method or plan which has been followed by many of the leading American corporations.

The stock has been set up in the form of options running for a maximum of three years, or such lesser period of time as the Committee may determine. Allotment of the stock will be made by the Committee to the key men of the Company on results accomplished. In other words, you will stand on your own record and participate in the stock purchase plan to the extent of your efforts, cooperation and results.

In order that our plan can begin to function, it has been decided now to tentatively allot ten shares of stock to each one of a selected list of key employees, subject to the following conditions:

1. This tentative allotment will only become definite on January 1st, 1945, and only provided the Company's operations for the year 1944 have been profitable.

2. The stock will be issued by the Company direct to the employee upon payment therefor at the rate of $5.00 per share and as directed by the Committee.

3. The stock cannot be paid for nor received by the employee before June 30th, 1945. Participation in the plan or receipt of stock is entirely contingent upon his being employed by Michigan Chemical at that time

The taxpayer was granted the first non-transferable option covering 150 shares at $5 a share by a

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and that such sales of stock are made in accordance with governmental laws or regulations.

4. Should employment with Michigan Chemical Corporation cease before June 30th, 1945, any allotments of stock which may be made to you on January 1st, 1945 will become null and void.

5. Should the employee on June 30th, 1945 so desire, arrangements will be made to extend the time for purchase of the stock to some future date to be determined by the Committee.

I am pleased to advise you that your name has been included in the names of key men to receive a tentative assignment of ten shares of Michigan Chemical stock, subject to the above conditions. The monthly figures during the year will show the results of your effort, both in your own department and in the plant as a whole. On or about January 1, 1945, a much larger portion of stock will be made available to the Committee for assignment to key employees on the basis of results accomplished. You may be assigned a greater or less amount of stock based entirely upon your individual results and that of the entire organization. Basic factors which should directly affect your accomplishments in departments will be labor costs both productive and non-productive, general expense items, maintenance of equipment, improvement in the efficiency of operations, increase in production, improvements in quality, simplified methods, new products, general operations in your department and cooperation with other direct and indirect departments.

May I suggest that you select those things wherein you can make the greatest contribution and strive to make the kind of record of which you and I may be proud.

May I also take this opportunity to congratulate you on being included in the initial list of those who have been selected as competent to perform outstanding service and thereby participate in the future of the Michigan Chemical Corporation.

Very truly yours,

(S.) T. C. Davis,
Executive Vice-President.

T.C. Davis:ag

letter from Mr. Davis, dated January 18, 1945.[3] (R. 144.) The fair market value of the stock in January, 1945, was $8.69 a share. (R. 145.) The option could be exercised on June 30 of that year if the recipient was then still employed by the corporation. The taxpayer was advised that the allotment of 150 shares to him was in recognition of his contribution and efforts in making the corporation successful. He was told that further allotments would be recommended in accordance with the plan and that it was up to him to justify his participation in the plan during the next two years.[4] (R. 18-20.)

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[3] The corporation granted similar stock options to thirty-six other key employees in 1945. (R. 144.)

[4] Following is the full text of the letter of January 18, 1945 (R. 18-20):

January 18, 1945

Mr. Philip J. LoBue
126 Leonia
Leonia, New Jersey

Dear Phil:

You will recall that I wrote you under date of June 29, 1944, advising that your name had been included in a selected list of key employees to participate in a stock purchase plan provided by the stockholders at their meeting in March, 1944. In that letter, you were advised that you had tentatively been allotted ten shares of stock, which could be purchased by you at $5.00 per share, subject to the following conditions:

1. This tentative allotment will only become definite on January 1st, 1945, and only provided the Company's operations for the year have been profitable.

2. The stock will be issued by the Company direct to the employee upon payment therefor at the rate of $5.00 per share and as directed by the Committee.

3. The stock cannot be paid for nor received by the employee before June 30th, 1945. Participation in the

The taxpayer was granted the second non-transferable option to purchase an additional 150 shares at $5 a share under similar conditions by a

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plan or receipt of stock is entirely contingent upon his being employed by Michigan Chemical at that time and that such sales of stock are made in accordance with governmental laws or regulations.

4. Should employment with Michigan Chemical Corporation cease before June 30th, 1945, any allotment of stock which may be made to you on January 1st, 1945, will become null and void.

5. Should the employee on June 30th, 1945, so desire, arrangements will be made to extend the time for purchase of the stock to some future date to be determined by the Committee.

I am pleased to advise you that the operations of the Company, though leaving much to be desired, were moderately profitable for the year 1944. The tentative allotment of stock made to you last June has now been changed and subject to the above conditions, you are definitely allotted 150 shares of the unissued common stock of the Michigan Chemical Corporation. This allotment of stock was made by the Committee and is in recognition of your contribution and efforts in making the operation of the Company successful.

The rights to subscribe to this stock are not transferable and will accrue to you directly providing all the conditions enumerated above are fully complied with.

As you know, we must continue to contribute our every effort toward the success of Michigan Chemical Corporation. There is much yet to be done to bring the Company along towards the attainment of our goal. This will require the most intensive work on the part of all of us during the current year. That we have a great opportunity is, I am sure, well known to you.

May I again congratulate you and suggest that you, as a stockholder, should be interested in seeing that the operations of the Company are as efficient as possible.

You will, of course, understand that further allotments of stock under our plan will be recommended by the Committee during 1945 and 1946 providing the conditions and

letter from Mr. Davis, dated January 1, 1946.[5] (R. 144.) The fair market value of the stock in January, 1946, was $19.25 a share. (R. 145.) The taxpayer was reminded that the extent of his participation in the plan was based on how well he handled his job during the year and that outstanding service was given added recognition in determining the number of shares assigned. He was told that it was only natural to expect a more rigid comparative appraisal of his efforts in the future; that any company was dependent upon its management and personnel for such success as might accrue to it; and that he was expected to contribute his share to the corporation's success.[6]

---

requirements are met. It is up to you to justify your participation in the plan during the next two years.

Very truly yours,

T. C. DAVIS,
Executive Vice-President.

T. C. Davis:ag.

[5] The corporation granted similar stock options to forty-seven other key employees in 1946. (R. 144.)

[6] Following is the full text of the letter of January 1, 1946 (R. 20-21):

New York, N. Y.,
January 1, 1946.

Mr. Philip J. LoBue
Leonia, New Jersey

Dear Phil:

It is with the greatest pleasure that I am writing to inform you that the Board of Directors of Michigan Chemical Corporation have approved the Committee's recommendation for the allotment of common stock of the Corporation to certain employees, for purchase at the price of $5.00 per share.

As you know, the stockholders at their meeting held in March, 1944, generously set aside 10,000 shares of the

Upon exercise of the two employee stock options in 1946,[7] the taxpayer received 300 shares of the

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Corporation's common stock for purchase, over a period of three years, by selected employees at the price of $5.00 per share, which was the then approximate market price. You have from time to time been advised of the requirements incident to your participation in this purchase plan.

For the year 1945 the Committee has allotted you 150 shares of the common stock of Michigan Chemical Corporation, subject to your acquisition of these shares from the company at the rate of $5.00 per share on or before March 21, 1947. I am sure that you appreciate that generally, the value of common stock equities is closely tied to the success or failure of the corporation issuing such stock.

The Committee's selection of the names of employees to receive the right to purchase this stock and the number of shares assigned to each selectee is determined by the Committee after a careful appraisal of the individual's contribution to the company in the way of job performance during the past year. In other words, the extent of your participation in the plan is based on how well you handled your job during the year. Outstanding service to the company is given added recognition in determining the number of shares assigned. In this connection, I would like to point out to you that it is but natural to expect a more rigid comparative appraisal of your efforts in the future.

It is important we keep in mind that this plan permits you to participate in the future of your company on what now appears to be a very attractive basis. Any company is dependent upon its management and personnel for such success as may accrue to it. You are expected to contribute your share to our success. As a potential stockholder, you personally have a very definite reason to strive for the successful operation of your company beyond the mere holding of a job.

I am sure you recognize that there is much waste in most of our operations. Waste of materials, steam, water and of still greater importance the waste of time and

(Footnote 7 on page 13)

corporation's stock for $8,100 less than its fair market value at that time. (R. 144, 146.)

The taxpayer was granted the third non-transferable option to purchase an additional 40 shares under similar conditions by a letter from Mr. Davis, dated January 2, 1947.[8] (R. 145.) The taxpayer was again advised that allocations of shares, as in previous years, had been determined after a careful appraisal of the employee's contribution to the corporation's progress during the past year. Mr. Davis, pointing out that the value of the shares allotted to the taxpayer was considerably greater than in the preceding year, congratulated the tax-

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labor. You should make every effort to correct these faults and where you know them to exist in part of the plant beyond your control, you should not hesitate to point them out to those responsible.

The Michigan Chemical Corporation is your company. You should feel in it the pride of ownership.

I congratulate you.

Yours very truly,

T. C. DAVIS,
Executive Vice-President.

T. C. Davis:ag.

(Reference for footnote 7 on page 12)

[7] On May 1, 1945, the taxpayer had given the corporation his promissory note for $750, payable on March 1, 1947, covering the 150 shares allotted to him under the first option. On January 3, 1946, the taxpayer had given the corporation his promissory note for $750, payable on March 1, 1947, covering the 150 shares allotted to him under the second option. (R. 27, 144.) On May 24, 1946, the taxpayer paid his two notes in the total amount of $1,500, and received the 300 shares of stock. (R. 144.)

[8] The corporation granted similar stock options to seventy-five other key employees in 1947. (R. 145.)

payer on having earned this recognition given to him and expressed the trust that the taxpayer's future services, suggestions and interest in the corporation's welfare would warrant even greater recognition.[9] (R. 21-22.)

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[9] Following is the full text of the letter of January 2, 1947 (R. 21-22):

January 2, 1947

Mr. Philip J. Lobue
Palisades Park, New Jersey

Dear Phil:

It is with the greatest of pleasure that I am writing to inform you that the Board of Directors of Michigan Chemical Corporation has approved the Committee's recommendation for the allotment of the available common stock of the corporation at the price of $5 per share.

This allocation represents the balance of the 10,000 shares of the corporation's common stock which was made available by the Stockholders at their meeting held in March, 1944, for allocation to and purchase by selected employees over a three year period at a price of $5 per share, which was the approximate market value at that time. This letter will supplement the information furnished you from time to time pertaining to your participation in this plan.

For the year 1946, the Committee has allocated you 40 shares of the available common stock of the Michigan Chemical Corporation, subject to your acquisition of these shares from the Corporation at a price of $5 per share on or before March 21, 1947. It is urged that all stock be purchased prior to March 10, 1947, to allow sufficient time for stock certificates to be issued by the stock transfer agents prior to the above mentioned expiration date.

It is anticipated that some of the employees to whom stock allotments have been made will have questions regarding the procedure for purchasing the stock or that possibly they will not have available all the cash necessary to enable them to purchase the stock prior to the expiration date. The foregoing or any other matters per-

Upon exercise of this third stock option in February, 1947, the taxpayer received an additional 40 shares of the corporation's stock for $580 less than its fair market value at that time. (R. 145, 146.)

In its income tax returns for 1946 and 1947 the corporation deducted the amount of the difference between the option price at which it sold stock

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taining to the stock allotments can be discussed with Mr. C. G. Woods.

The allocations for 1946, as in past years, have been determined by the Committee after a careful appraisal of the employee's contribution to the corporation's progress during the past year. The allocations are not as large as in past years. This is due to the fact that the number of shares available was less than in prior years and the number of employees to whom allocations were made was greater than previously. However, the value per share allocated is considerably greater this year than in previous years.

Again I wish to call your attention to the fact that these allocations afford you an opportunity to become a stockholder and thus participate in the future earnings of the corporation. The future progress and earnings of the corporation are largely dependent upon the loyal cooperation and efforts of each of its employees. The corporation's plans for 1947 include further expansion which should bring to you greater opportunities for participation in the future of your company both as an employee and stockholder. Incidentally, an employee should feel a certain amount of pride in also being a stockholder.

I congratulate you on having earned this recognition given to you by the Committee and trust that your future services, suggestions and interest in the corporation's welfare will warrant even greater recognition.

Very truly yours,

T. C. DAVIS,
President.

T. C. Davis: ag

to key employees during those years and the fair market value of that stock at such times. No deduction was taken by the corporation in its income tax return for 1945 with respect to stock allocated to employees under the stock option plan; nor did the corporation apply for or receive approval of the Salary Stabilization Unit for the granting of such options to its key employees. (R. 14.)

The taxpayer's returns having failed to reflect his receipt or exercise of the employee stock options, the Commissioner issued a deficiency notice in which he determined that, when the taxpayer in 1946 and 1947 received his employer-corporation's stock for less than its fair market value through exercise of the employee stock options, the taxpayer received taxable income in the nature of additional compensation in the amounts of $8,100 and $580 respectively. (R. 146.) A petition for redetermination having been filed, the Tax Court entered a decision in favor of the taxpayer, concluding that his exercise of the employee stock options did not result in his receipt of taxable income in the nature of compensation because the options had been granted to him for the purpose of providing him with a proprietary interest in the business, and holding invalid Section 29.22(a)-(1) of Treasury Regulations 111, as amended by T. D. 5507, 1946-1 Cum. Bull. 18, upon which the Commissioner relied. (R. 146-149.)

Agreeing that the Treasury regulation was invalid, the Court of Appeals for the Third Circuit affirmed the Tax Court's decision. In reaching

its conclusion, the Third Circuit reasoned (R. 162-163) that, notwithstanding the broad definition of gross income contained in Section 22(a) of the Internal Revenue Code of 1939, the taxpayer upon exercise of an employee stock option could receive an immediate economic benefit which, although not a gift, would not constitute taxable income but would be considered merely "incidental" if the intent of the employer-corporation in issuing the option was to have the taxpayer acquire a proprietary interest in its business.

SUMMARY OF ARGUMENT

In broadly defining gross income in Section 22 (a) of the Internal Revenue Code of 1939, Congress intended to tax all gains except those specifically exempted. The question in this case is whether the taxpayer realized a taxable gain in 1946 and 1947, when he was permitted to acquire his employer-corporation's stock for a fraction of its fair market value through the exercise of three stock options which that corporation had previously issued to him. Clearly, the taxpayer thereby received an economic benefit from his employer, and that benefit did not represent a gift. It represented income in the nature of compensation and, contrary to the conclusion of the courts below, its taxable nature was not affected by the employer's desire to have the taxpayer acquire a proprietary interest in its business. Accordingly, the Treasury Regulations which require such an employee's gain to be treated as compensation and included in

his gross income (unless shown to be a gift) constitute a valid interpretation of Section 22 (a).

The facts show that the economic benefit derived by the taxpayer represented compensation, i.e., was in consideration for his services, past, present, and future, as an employee of the corporation. On informing the taxpayer of its stock option plan, and when it issued each of the stock options to him, his employer emphasized that the options were being issued to him in recognition of his services as a key employee, and that the amount of optioned stock allocated to him was based on his accomplishments as such employee. That economic benefit was also treated as compensation paid in tax returns filed by the employer.

Nor did the employer's desire to have the taxpayer acquire a proprietary interest preclude his realization of taxable income in the nature of compensation. A corporation must necessarily intend any person to whom it sells its stock to acquire a proprietary interest in its business. Where the corporation sells an employee such stock for less than its fair market value, the employee receives an economic benefit in addition to a proprietary interest. There is no inconsistency involved in an employee's acquiring a proprietary interest and at the same time receiving taxable income in the nature of compensation. On the contrary, the two conclusions are consistent and complementary. Where, as here, no gift is involved, and a taxpayer must render services or serve as an employee to acquire a particular economic benefit, that benefit

represents taxable income in the nature of compensation, even though the employer conferring that economic benefit upon him may have had a "proprietary interest" motive. Unless the corporation intends to make a gift, the acquisition of a proprietary interest by its employees is but a means to an end, the ultimate end being the concrete reflection of that interest in valuable services by the employee. Thus, the employer's desire that his employee acquire a proprietary interest serves to confirm rather than negate the conclusion that the taxpayer's economic benefit represents compensation. Accordingly, the Regulations struck down by the courts below state an undeniable conclusion, namely, that (unless the facts show a gift) an economic benefit conferred because of the employment relationship is necessarily in return for services rendered or to be rendered, and hence represents taxable income in the nature of "compensation."

ARGUMENT

The Treasury Regulations, Under Which an Employee Realizes Taxable Income in Acquiring Stock in His Employer Corporation For Less Than Fair Market Value, Represent a Reasonable and Valid Interpretation of the Statute. The "Proprietary Interest" Test Applied by the Lower Courts Is Illogical and Erroneous

A. *In general: The nature of the issue.*

The issue in this case can be posed by a simple illustration. Suppose a corporation transfers an automobile worth $3,000 to an employee who pays the corporation $1,000 for it. Does the employee

pay an income tax on the $2,000 difference? The answer is, of course, that it depends on whether or not the transaction involved a gift to the extent of $2,000. If it appears from the facts that it was not a "gift of property", which is exempt from income tax under Section 22(b)(3) of the 1939 Code, *supra*, pp. 2-3, but rather that the transaction was an incident of the employer-employee relationship (that is to say, the employer transferred the property to the employee at less than fair market value, not because it was legally obligated to do so, but because in doing so it added to the employee's incentives for doing a good job, somewhat like a Christmas bonus), everyone agrees that the $2,000 economic gain received by the employee is in the nature of "compensation" taxable to him even though, strictly speaking, it is not part of his regular salary or wages.

The instant case involves the transfer to an employee not of an automobile but of the corporation's stock. Here an employee whose annual salary for the years 1946 and 1947 was $6,600 received from his employer, in addition, the right, which he exercised, to purchase 300 shares of stock worth $9,600 for $1,500, in 1946, and 40 shares of stock worth $780 for $200, in 1947. Such transactions, as was noted in the petition for certiorari, are becoming increasingly widespread. The popularity of this corporate practice is attributable, in part, to lower court decisions which, erroneously we submit, permit the favored employees to receive economic gain, in the form of the corporation's stock at a

bargain price, free of the same kind of tax burden borne by employees who receive their compensation in the form of cash or other types of property.

This Court held in 1945, in *Commissioner* v. *Smith*, 324 U.S. 177, that an employee can derive taxable income, in the nature of "compensation for personal service", when he exercises an option to purchase shares of stock at a price less than market value. Hence it is clear from the *Smith* case that, for tax purposes, there is nothing peculiar or unique about the transfer of corporate stock which differentiates it from transfers of other kinds of property. It is not the *nature* of the property transferred, therefore, which makes a difference in the stock-option situation. Where, then, lies the difference—and the explanation for the increasing popularity of the practice, for tax-reduction purposes, of rewarding valued employees by giving them options to buy stock in the employer corporation at lower prices than they would have to pay on the open market?

The explanation lies in the so-called "proprietary interest" test which has been developed, without any explicable basis in the statute or regulations, by the Tax Court and some Courts of Appeals. Perhaps the most persuasive statement of the "proprietary interest" test, and the reasons underlying it, are contained in Judge Maris' opinion for the court below (R. 162-163). It states:

> It is denying the facts of economic life to assert that every grant of a stock option to a corporation's employee is necessarily addi-

tional compensation to the extent that at the time of exercise the market value of the stock exceeds the option price. For it is a well known and common practice of American business corporations to seek to retain the continued interest in the business of their key employees by inducing them through favorable stock options to acquire a proprietary interest as stockholders. In a great many such cases the immediate economic benefit to the employee is minor, incidental and, often, quite fortuitous. Such transactions are, however, not gifts for there is a very real consideration to the corporation, the continued interest of a key employee. There are, of course, other cases in which the element of compensation is the important one. But the fact that there is an element of immediate economic benefit does not exclude the conclusion that the option was given solely to provide the employee with a proprietary interest and that the immediate benefit was purely incidental and not compensatory.

In short the Court of Appeals thought the controlling question is one of fact: if compensation to the employee was intended, the gain he receives is taxable income; if, however, the employer intended that the employee acquire a proprietary interest in the business, no taxable gain results. In other words, "compensation" and "acquisition of a proprietary interest" are to be treated as

mutually exclusive categories. In every case taxability would hinge upon a question of fact: what was the employer's intention? And the answer must be either "compensation" or "proprietary interest", one or the other, and never both.

The Government submits, however, that this test of taxability is patently illogical and erroneous under the statute. There is no inconsistency, as a matter of fact, between an intention to increase a key employee's compensation by allowing him to acquire the corporation's stock at a price substantially less than its value, and a desire that he acquire a proprietary interest in the business. The two motives, far from being necessarily contradictory, as the court below thought, are usually complementary. An employer may, and in most cases probably does, have both objects in mind in granting an option.

If there is an intention to "compensate", in the sense that the options are given as an incident of the employer-employee relationship and not as a gift, the gain realized by the employee is taxable to him as income, even though the employer may also have had a "proprietary interest" motive. The presence of the latter fact should be immaterial, so far as taxability is concerned.

It is possible, of course, that an option may be given purely as a gift, for donative reasons wholly uninfluenced by the fact that the donor happens to be the donee's employer. Where that is the case, obviously no taxable income is realized by

the employee upon acquisition of the stock, because it is a "gift of property" excluded from tax under Section 22(b)(3). But there is no contention here that this case involves a "gift of property". In the passage from its opinion quoted, *supra*, pp. 21-22, the Court of Appeals expressly recognized that these transaction are "not gifts for there is a very real consideration to the corporation, the continued interest of a key employee." It recognized, also, that the employee, when he acquired the stock, derived an "immediate economic benefit." Yet it held that the receipt of such benefit was not taxable income because it is "minor, incidental and, often, quite fortuitous." But we know of no authority, either in the statute or judicial precedents, for holding that gains otherwise taxable are not to be taxed because they are "incidental", or "fortuitous". Unless the gains are found to have been received as gifts, they constitute income. We agree with the lower courts that in cases of this kind there is a controlling question of fact. But the inquiry is not, was this "compensation" or was it "acquisition of a proprietary interest"? Rather, the question is, simply, was this a "gift" which the employer made? Or was it given in recognition of, and in consideration (though not in any technical legal sense) for, the employee's interest and services, past, present, and future? If so, it is, as correctly stated in the Regulations, in the nature of "compensation" and hence taxable as income.

B. *The statute and the Regulations*

Section 22 (a) of the Internal Revenue Code of 1939, *supra*, p. 2, defines the term "gross income" to include:

> * * * gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid * * * or gains or profits and income derived from any source whatever.

In so defining gross income, as it has ever since 1913,[10] Congress exerted "the full measure of its taxing power" and intended "to tax all gains except those specifically exempted." *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 429-430. See *Rutkin* v. *United States*, 343 U.S. 130; *Commissioner* v. *Jacobson*, 336 U.S. 28, 49; *Helvering* v. *Bruun*, 309 U.S. 461, 468; *Helvering* v. *Clifford*, 309 U.S. 331, 334; *Douglas* v. *Willcuts*, 296 U.S. 1, 9; *Irwin* v. *Gavit*, 268 U.S. 161, 166; *Robertson* v. *United States*, 343 U.S. 711. And, while Congress, in Section 22 (b), has acted to exempt certain described gains from tax, such as gifts of property in Section 22 (b)(3), these exemptions are strictly construed; and it is incumbent upon the taxpayer claiming the benefit of any exemption to establish that his gain comes within the excluded category specified by Congress. *Helvering* v. *Northwest Steel Mills*, 311 U.S. 46, 49; *Commissioner* v. *Jacobson*, *supra*, p. 49.

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[10] Section II B, Income Tax Act of 1913, c. 16, 38 Stat. 114.

Where an employee, as a consequence of his employment, is permitted to buy property from his employer at less than true value, taxable income is received. Such a transaction is not the same as a simple purchase of property in which there will be no tax consequences until a later sale or other disposition of the property. See *Palmer* v. *Commissioner*, 302 U.S. 63, 68-69. In the former situation, the person acquiring the property not only pays cash but also renders services as an employee so that the difference between the actual value of the property and the price paid for it is attributable to his employment. See *Geeseman* v. *Commissioner*, 38 B.T.A. 258, 263. The employee is buying the property, partly for cash and partly in exchange for his services, the cash price paid and the value of the services rendered or to be rendered being the consideration for the property received. The situation is the same as though the employee, in addition to his normal salary, has received an extra cash payment which he, in turn, uses in paying the fair market price of the property. The acquisition of property on the sale of services, consequently, results in a closed taxable transaction even though a simple purchase of property does not. See *Commissioner* v. *Smith*, 324 U.S. 177, rehearing denied, 324 U.S. 695, where this Court held that an employee could receive compensation in the form of a bargain purchase.

Treasury Regulations interpreting the provisions of Code Section 22 (a) and its statutory predecessors have long provided that the employee

realizes taxable income when, by reason of his employment, he receives property from his employer for a price which is substantially less than fair market value. The regulation which the courts below held invalid, Section 29.22(a)-1 of Treasury Regulations 111, as amended by T.D. 5507, *supra*, pp. 4-5,[11] provides:

> If property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value is in the nature of compensation and

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[11] This regulation, as so amended, is not applicable to the option issued on January 18, 1945. The regulation in effect with respect to that option provides (Section 29.22(a)-1 of Treasury Regulations 111, *supra*, pp. 3-4):

> If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. * * *

As we shall establish, the courts below also erred in concluding that, under that regulation, no compensatory income was realized through the medium of that option.

> shall be included in the gross income of the employee. * * *

It will be observed that this regulation comes into operation only upon the concurrence of certain conditions stated or implicit. First, there must be a transfer of property from employer to employee. Second, the regulation necessarily implies that the transfer of property must be peculiar to or occasioned by the employment relationship. Consequently, the regulation does not apply where a true gift is involved. See *Bogardus* v. *Commissioner*, 302 U.S. 34. Finally, the fair market value of the property must be greater than the amount paid for it by the taxpayer-employee. It is our position that this regulation—which must, of course, be read together with the regulation interpreting the statutory provision exempting gifts from income tax—represents a proper construction of Section 22 (a) of the Internal Revenue Code of 1939; and that, accordingly, the courts below were wrong in invalidating the regulation for failing to provide for some middle ground between a tax exempt gift and taxable compensation in the type of situation exemplified by this case.

C. *Under the statute and Regulations the taxpayer clearly received income in the nature of compensation.*

A review of the undisputed facts in this case compels the conclusion that the taxpayer received taxable income in the nature of compensation

through the medium of the three employee stock options.[12] Since in the instant case, the option price was substantially less than the fair market value of the optioned stock, both at the time the taxpayer received the options and at the time he exercised them,[13] it cannot be seriously contended that he did not receive an economic benefit through the medium of those options. Indeed, neither the Tax Court nor the Court of Appeals attempted to deny the uncontrovertible fact that the taxpayer received an immediate economic benefit when he was enabled to buy the stock at a price considerably less than its true value. In view of this Court's decision in *Commissioner* v. *Smith*, 324 U.S. 177,

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[12] We do not, of course, take issue with the underlying facts found by the Tax Court, which merely reflect the uncontroverted evidence. We do, however, contest the correctness of its ultimate conclusion which was stated in its findings of fact (R. 146) that the economic benefits conferred on the taxpayer were not "compensation for services"—a conclusion which, as its opinion makes clear (R. 146-149), the Tax Court thought inevitably followed from its finding that the options were granted to give him a proprietary interest. The same erroneous legal theory was adopted by the Court of Appeals.

[13] The number of shares of stock covered by each of the three options, the option price of each share, the fair market value of each share when the options were issued, and the fair market value of each share when acquired by the taxpayer, were as follows (R. 143, 144, 145):

Option issued	Number of shares covered by option	Option price per share	Fair market value when option was issued	Fair market value when stock was acquired
January, 1945	150	$5.00	$ 8.69	$30.50
January, 1946	150	5.00	19.25	30.50
January, 1947	40	5.00	?	19.50

rehearing denied, 324 U.S. 695, it cannot be disputed that in receiving such economic benefit the taxpayer received taxable income if that economic benefit represented compensation and was not an exempt "gift of property". The criterion for determining whether that economic benefit represented compensation within the meaning of Code Section 22 (a) is whether it was "in return for services" rendered or to be rendered. *Robertson* v. *United States*, 343 U.S. 711, 714. See also *Old Colony Tr. Co.* v. *Commissioner*, 279 U.S. 716, 729.

Initially, on informing the taxpayer of the proposed stock option plan, his employer-corporation repeatedly stated that the allotment of shares to key men would be based "on results accomplished". The taxpayer was told that participation in the plan and the receipt of stock thereunder was "entirely contingent upon his being employed" by the company. The taxpayer was advised—"you will stand on your own record and participate in the stock purchase plan to the extent of your efforts, cooperation and results". Basic factors which should directly affect the taxpayer's accomplishments were enumerated, and it was suggested that he select those things in which he could make the greatest contribution. Finally, he was congratulated upon being included among those selected as "competent to perform outstanding service and thereby participate in the future of the Michigan Chemical Corporation". (R. 17-18.)

On issuing the first stock option allotting 150

shares to the taxpayer, his employer-corporation informed him (R. 19):

> This allotment of stock was made by the Committee and is in recognition of your contribution and efforts in making the operation of the Company successful.

At the same time, with respect to future allotments, the taxpayer was told (R. 20):

> It is up to you to justify your participation in the plan during the next two years.

On issuing the second stock option, allotting an additional 150 shares to the taxpayer, his employer-corporation pointed out that generally the value of common stock equities is closely tied to the success or failure of the corporation issuing such stock. (R. 20.) The taxpayer was told (R. 20-21):

> The Committee's selection of the names of employees to receive the right to purchase this stock and the number of shares assigned to each selectee is determined by the Committee after a careful appraisal of the individual's contribution to the company in the way of job performance during the past year. In other words, the extent of your participation in the plan is based on how well you handled your job during the year. Outstanding service to the company is given added recognition in determining the number of shares assigned. In this connection, I would like to point out to

you that it is but natural to expect a more rigid comparative appraisal of your efforts in the future.

It is important we keep in mind that this plan permits you to participate in the future of your company on what now appears to be a very attractive basis. Any company is dependent upon its management and personnel for such success as may accrue to it. You are expected to contribute your share to our success. As a potential stockholder, you personally have a very definite reason to strive for the successful operation of your company beyond the mere holding of a job.

On issuing the third stock option, allotting an additional 40 shares to the taxpayer, his employer-corporation advised him (R. 22):

> The allocations for 1946, as in past years, have been determined by the Committee after a careful appraisal of the employee's contribution to the corporation's progress during the past year.

Finally, after pointing out that "the value per share allocated is considerably greater this year than in previous years", the employer-corporation congratulated the taxpayer "on having earned this recognition given to you by the Committee" and told him of its trust that even greater recognition would be warranted for "your future services,

suggestions and interest in the corporation's welfare". (R. 22.)

If more were needed to show that the stock options were issued to the taxpayer in return for his services, it would be found in the fact that the corporate-employer claimed corresponding deductions in its tax returns. Thus, on permitting the taxpayer to purchase its stock for substantially less than the stock's fair market value in 1946 and 1947, the employer-corporation deducted the difference in its income tax returns for those years.[14] (R. 145.) Noteworthy, too in this connection, is the fact that by taking these deductions, the employer-corporation not only ratified its accountant's treatment of the options as representing compensation for services, but also did so after its president, Mr. Davis (who was also the recipient of 5,000 shares of optioned stock not here involved) had attempted to convince those accountants that the options were not compensatory. (R. 134-135.)

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[14] For the year 1945, the corporation did not claim a tax deduction with respect to stock options granted to employees in that year; the corporation had not made an application for and had not received approval from the Salary Stabilization Unit for granting such stock options. (R. 14.) For salary stabilization purposes such options constituted salary payments. Mim. S.S.U. 65, August 15, 1944 (1945 C.C.H., par. 53.105). Any unauthorized increases in salary would have been both unlawful and nondeductible. Stabilization Act of 1942, c. 578, 56 Stat. 765 (50 U.S.C. Appendix, 1946 ed., Secs. 961-971); 32 Code of Federal Regulations (1943 Supp.), c. XVIII, Sec. 4001.10; Sec. 29.23(a)-16 of Treasury Regulations 111.

D. The "proprietary interest" test, applied by the courts below, is erroneous under the statute.

The theory of the courts below is that in employee stock option transactions employees do not receive taxable income (which is compensatory or comes within any taxable category) if the employer-corporation in issuing the options is motivated by a desire to grant them a proprietary interest in its affairs. Both courts seem to regard such a motive as being the very antithesis of an intention to pay compensation. Thus, the opinion of the Tax Court, from which four judges dissented, while recognizing that (R. 149) an element of compensation and the desire to grant a proprietary interest may exist together, decided the case on the assumption (R. 146) that either one or the other had to be controlling. That is, it concluded that (R. 146) "If the options were intended as additional compensation," taxable income would have been received by the taxpayer, but "If the options were granted to provide him with a proprietary interest in the business," no taxable gain could be "recognized when the options are exercised." [15] Finding, in accordance with evidence

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[15] Other cases have also been decided on such a basis. We cite, as typical: *Adams* v. *Commissioner*, 39 B.T.A. 387; *Rosenberg* v. *Commissioner*, 20 T.C. 5; *Bowen* v. *Commissioner*, decided July 22, 1954 (1954 P-H T.C. Memorandum Decisions, par. 54,207); *Commissioner* v. *Straus*, 208 F. 2d 325 (C.A. 7th); *Bradner* v. *Commissioner*, decided June 4, 1952 (1952 P-H T.C. Memorandum Decisions, par. 52,175), affirmed *per curiam*, 209 F. 2d 956 (C.A. 6th).

adduced by the taxpayer, that the employer granted the options because of a desire to give the employees an opportunity of acquiring a stock interest, the Tax Court concluded that the options were granted to the taxpayer (R. 146) "to give him a proprietary interest in the Corporation, and not as compensation for services." On that basis, it held that no taxable income was received when the taxpayer was enabled to acquire the stock at less than its true value.[16]

The Court of Appeals followed a similar line of reasoning. It stated and accepted as a correct principle of law the assumptions that (R. 160) stock options are *either* intended as additional compensation *or* are intended to grant a proprietary interest, and that in the latter situation no taxable income is realized by the employee on the exercise of the option. It stated that (R. 160) "whether the grant of the option *is the one or the other*" is "in every case a question of fact." (Emphasis added.)

The theory of the courts below, as has been shown *supra*, pp. 23-24, will not withstand analysis. In the first place, there is no inconsistency involved in an employee's acquiring a proprietary interest and at the same time receiving taxable income in the na-

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[16] The Tax Court did also note (R. 149) that the option price slightly exceeded the fair market value of the stock when the plan was first adopted and the option price was established. This fact, however, loses significance when it is borne in mind not only that the employees were not bound to exercise the options, but also that the option price was substantially below the fair market value of the stock both when the options were actually issued and when they were exercised. See fn. 13, *supra*, p. 29.

ture of compensation on the exercise of the stock option. A corporation must necessarily intend any person to whom it sells its stock, by option or otherwise, to acquire a proprietary interest. Consequently, it is a truism that whenever an employer-corporation grants options to its employees to purchase its own stock, it necessarily intends to give them an opportunity to acquire a proprietary interest in its business. The employee would, of course, acquire a proprietary interest if he paid the full fair market value for the stock. And, where the acquisition of the stock is at a price less than that at which such stock is being sold to others, the employee obviously receives an economic benefit in addition to a proprietary interest.

Secondly, we are dealing here with the express language of a statute. As already observed, Congress has defined taxable income in Section 22 (a) in the most sweeping terms. While the statute expressly exempts certain types of income, including "gifts of property" (Section 22 (b) (3)), there is no claim that the admitted economic gain which the present taxpayer realized comes within these exceptions. Congress has supplied no express or implied basis to support the view that taxation of an admitted economic gain received by an employee should be defeated because the employer is motivated by a desire to grant the employee an opportunity of acquiring a proprietary interest in its business.

That Congress has acted on an assumption opposite to that employed by the courts below, namely,

that the employer's motive of granting a proprietary interest is without significance, is evident from its enactment of the restricted stock option provisions contained in Section 130A of the Internal Revenue Code of 1939, as added by Section 218 of the Revenue Act of 1950, c. 994, 64 Stat. 906, now reenacted as Section 421 of the Internal Revenue Code of 1954. When Congress enacted those restricted stock option provisions, it gave preferential tax treatment to employee stock options meeting certain prescribed qualifications and safeguards.[17] See S. Rep. No. 2375, 81st Cong., 2d Sess., pp. 59-60 (1950-2 Cum. Bull. 483, 526). Under those provisions, the tax on the gain realized by an employee when he acquires his employer-corpora-

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[17] Among the conditions which must be met by a "restricted" stock option in order to qualify for preferential treatment under the 1950 amendment are the following:

The option price at the time of issuance must be 85% or more of the fair market value of the stock. The option must not be transferable *inter vivos*. The individual must exercise the option during his employment or within three months after he ceases to be an employee. The individual must not dispose of the stock within six months after its acquisition or within two years after acquisition of the option. The recipient of the option must not own, directly or indirectly, stock possessing more than 10% of the total combined voting power of all classes of stock.

tion's stock for less than its fair market value through the exercise of a restricted employee stock option is postponed until the employee sells the stock. At such time, his gain (which is measured by the difference between the option price and the fair market value of the stock when the option is granted or when the stock is disposed of, whichever is less) is taxed as ordinary income unless the option price was 95% or more of the fair market value of the stock when the option was issued. It will be noted that, even in the precise area where Congress has provided this carefully limited special treatment for employee stock options, the employer's intent to grant a "proprietary interest" is not a relevant factor in determining tax consequences.

The "proprietary interest" theory, used by the courts below to justify their conclusion that no income is realized, if it were valid, would defeat the Congressional purpose of granting some special tax benefits only where the prescribed conditions have been met. That is, if the courts below are correct in their conclusion that the economic gain conferred on the employee is not embraced by the all-inclusive definition of income contained in Section 22 (a) where the motive is one of granting a proprietary interest, there will be no need for complying with the statutory safeguards in any other situation where a similar motive exists. And the vice of the decisions below goes further—unlike the statutory provisions dealing with restricted stock options which insure that the employee will eventually be

taxed with *ordinary income* (except where the initial spread is 5% or less), the decisions of the courts below not only postpone the tax until the stock is sold, but also have the effect of taxing the entire gain at that point as *capital gain* at preferential rates and of freeing his gain from any income tax whatsoever if the taxpayer dies without having sold the stock.

We submit, accordingly, that Congress could not have shared the view of the courts below.

Further, under Section 22(a) (in the absence of an intention to make a gift) it is quite unimportant that the employer may not fully appreciate that the intended effect of conferring an economic benefit on its employees results in the payment of compensation. So long as the economic benefit is "connected with, or conditioned on, rendering services and thus connected with his employment," it seems plain that the employee was intended to receive compensation which is taxable income under Section 22 (a). *Van Dusen* v. *Commissioner*, 8 T.C. 388, 393, affirmed, 166 F. 2d 647 (C.A. 9th). As the court stated in *Bass* v. *Hawley*, 62 F. 2d 721, 723 (C.A. 5th), it was the purpose of Congress in Section 22 (a) that—

> all receipts in whatever form that come because of labor and service, whether payment could be compelled or not, shall be taxed as arising from labor.

Consequently, where a taxpayer must perform services or serve as an employee (as is true here) to

receive a certain economic benefit, and where no gift or other type of excludable income is involved, the employer-corporation necessarily intends the consequences of its actions, i.e., to confer compensation on the employee for services rendered or to be rendered.

Nor can it be important, in applying the broad sweep of Section 22 (a), that the employer who confers an economic benefit on his employee as a reward for services rendered or as an inducement for the rendering of future services, is also actuated by motives (whether or not those are the principal or dominating ones) which are not necessarily associated with an intent to compensate. Thus, in *Robertson* v. *United States*, 343 U.S. 711, Reichhold, in granting an award for the best symphonic work, was motivated principally by the desire to benefit the public at large by bringing to it the best new music written in the Americas and to benefit the Detroit Symphony Orchestra by giving it certain rights in the winning composition. Notwithstanding these philanthropic motives and the lack of any economic advantage to Reichhold, it was held that the taxpayer in *Robertson* received taxable income when he submitted a composition, which he had previously written, and received an award of $25,000. This Court said (p. 714):

> Where the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it.

Although, as is demonstrated by *Robertson*, it is irrelevant that the employer may be actuated by

other motives—taxable income being received so long as the economic benefit given the employee is related to services rendered or to be rendered—it should be observed that the motive of granting a proprietary interest in this case cannot actually be divorced from an ultimate intent to compensate. Thus, T. C. Davis, an officer and director of the company, who was the only witness, testified that his original purpose in suggesting the option plan was to (R. 133)—

> provide some means to have our key employees have a proprietary interest in the company, because it has always been my feeling that is better for a company and better for the employees.

But there is only one way in which a plan giving employees a proprietary interest in the business could possibly be "better" for the employer-corporation; it must result in the rendering of further services by employees who are thereby induced to remain in employment or are induced to work harder or more efficiently.

From a general viewpoint, as well as in the context of the particular facts of this case, it seems impossible that an employer, in providing its employees with the opportunity of purchasing its stock on favorable terms, can confer an economic advantage which is something other than compensation simply because it is actuated by a desire that the employees acquire a proprietary interest. No matter what the terms used to describe the advantages which flow to the corporation from hav-

ing its key employees occupy the position of stockholders, i.e., increased loyalty, interest, devotion, pride, etc., they refer to the same ultimate purpose, namely, the rendition of services by such employees. The proprietary interest theory, namely, that some corporations confer on certain of their servants the right to become a proprietor of the corporation (for less than other buyers are prepared to pay for that same right) not in return for services rendered or to be rendered, but merely from a desire to see the employee a proprietor of the corporation, is analytically incomplete. It describes two things, but not an essential third. It describes the corporate motive in so far as a corporation can have a motive. It describes what it is that the corporation is motivated to give the employee. But it fails to answer the question whether the corporation is to get anything and, if so, what. If the corporation gets nothing, the transaction is a waste of corporate assets.[18] If it gets some-

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[18] As a general rule of corporate law, any distribution of valuable property rights by a corporation is an actionable waste of corporate assets unless the corporation receives in return not only services, but services commensurate in value with the value of property distributed. *Rogers* v. *Hill*, 289 U.S. 582; *Commissioner* v. *Bonwit*, 87 F. 2d 764, 765 (C.A. 2d), certiorari denied, 302 U.S. 694. Recent decisions with respect to employee stock option plans have made it clear that the principles enunciated in *Rogers* v. *Hill*, *supra*, apply to distribution by way of options to buy the distributing corporation's stock. *Elster* v. *American Airlines*, 100 A. 2d 219 (Del. Ch.); *Eliasberg* v. *Standard Oil Co.*, 92 A. 2d 862 (N.J. Super.); affirmed *per curiam*, 97 A. 2d 437 (N.J.); *Kaufman* v. *Shoenberg*, 91 A. 2d 786 (Del. Ch.); *Gottlieb* v. *Heyden Chemical Corp.*, 92 A. 2d 594 (Del.); *Kerbs* v. *California Eastern Air-*

thing, it is not enough to say that it gets "interest", "loyalty", etc. A business corporation does not thrive on emotional attitudes or sentiments directed toward it, unless they result in some concrete advantage in the conduct of its business. A vendor to, or a purchaser from, or a servant of the corporation who has a stake in the corporation's fate may well give the corporation a trading advantage or a service advantage. But a person who neither sells to, buys from, nor serves the corporation is not the least bit of use to it no matter how much he desires the corporation to succeed. A business corporation exists to make money, and, from the point of view of the corporation as an entity pursuing its one purpose, it is a matter of complete indifference whether its stock is issued to disinterested A or interested B unless B's interest is reflected in some way to its advantage.

We submit that the Court of Appeals, in speaking of the "facts of economic life" and in taking note of the corporate practice of giving favorable stock options in order to (R. 162) "seek to retain the continued interest in the business of their key employees" and in conceding that the economic benefits conferred on such employees are not gifts because (R. 163) "there is a very real consideration to the corporation" in the "continued interest

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ways, 90 A. 2d 652 (Del.), reargument denied, 91 A. 2d 62; *Truncale* v. *Universal Pictures Co.*, 76 F. Supp. 465 (S.D. N.Y.); *Holthusen* v. *Edward G. Budd Mfg. Co.*, 53 F. Supp. 488 (E.D. Pa.).

of a key employee", was describing the basic elements of compensation.[19] Yet, strangely enough, the Court of Appeals was so convinced that this was the antithesis of compensation that it struck down the Regulations for failing to incorporate such a principle.

In short, the motive here of granting the employees an opportunity of acquiring a proprietary interest is an inseparable aspect of an ultimate intent to grant compensation. The nexus between the two is undeniable even though the employer may have been honestly unaware of it and may not have thought through the intended effect of its granting such an economic benefit. Accordingly, far from detracting from or standing in opposition to the intent to compensate (an intent conclusively established by the evidence discussed at pp. 28-33, *supra*) the employer's desire here to grant a proprietary interest in its business is in full harmony with the ultimate conclusion for which we contend, namely, that the taxpayer did receive an economic benefit which is taxable under Section 22(a). In this respect, the present case is a stronger one than *Robertson* where an extraneous motive, having no relationship to an intent to compensate, was present.

In view of the foregoing, we believe that the

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[19] As Dean Griswold has said (Surrey & Warren, *Federal Income Taxation* 603 (Second ed., 1953)):

> I really do not see how it is possible to give a stock option to an executive which is not available to anyone else, without its being compensation.

Treasury Regulations (far from being invalid, as held by the court below for failing to adopt a "proprietary interest" theory) represent a correct interpretation of Section 22(a) in the kind of circumstances of which this case is typical.[20] Since, as we have shown, the "proprietary interest" concept is not opposed to (but indeed is an aspect of) the granting of compensatory income, the Court of Appeals erred in striking down the Regulations as though they were an incorrect interpretation of the basic statute. Where no gift is involved, the Regulations state an undeniable conclusion, namely, that an economic benefit conferred because of the employment relationship is necessarily in return for services rendered or to be rendered, and hence represents compensatory income.

As we have previously indicated (See fn. 11, *supra*), the Regulations applicable to the option issued on January 18, 1945, provided that on an employee's purchase of property from his employer at a price less than fair market value the difference represents taxable income "to the extent that such difference is in the nature of compensation." In view of the foregoing discussion, we believe that the

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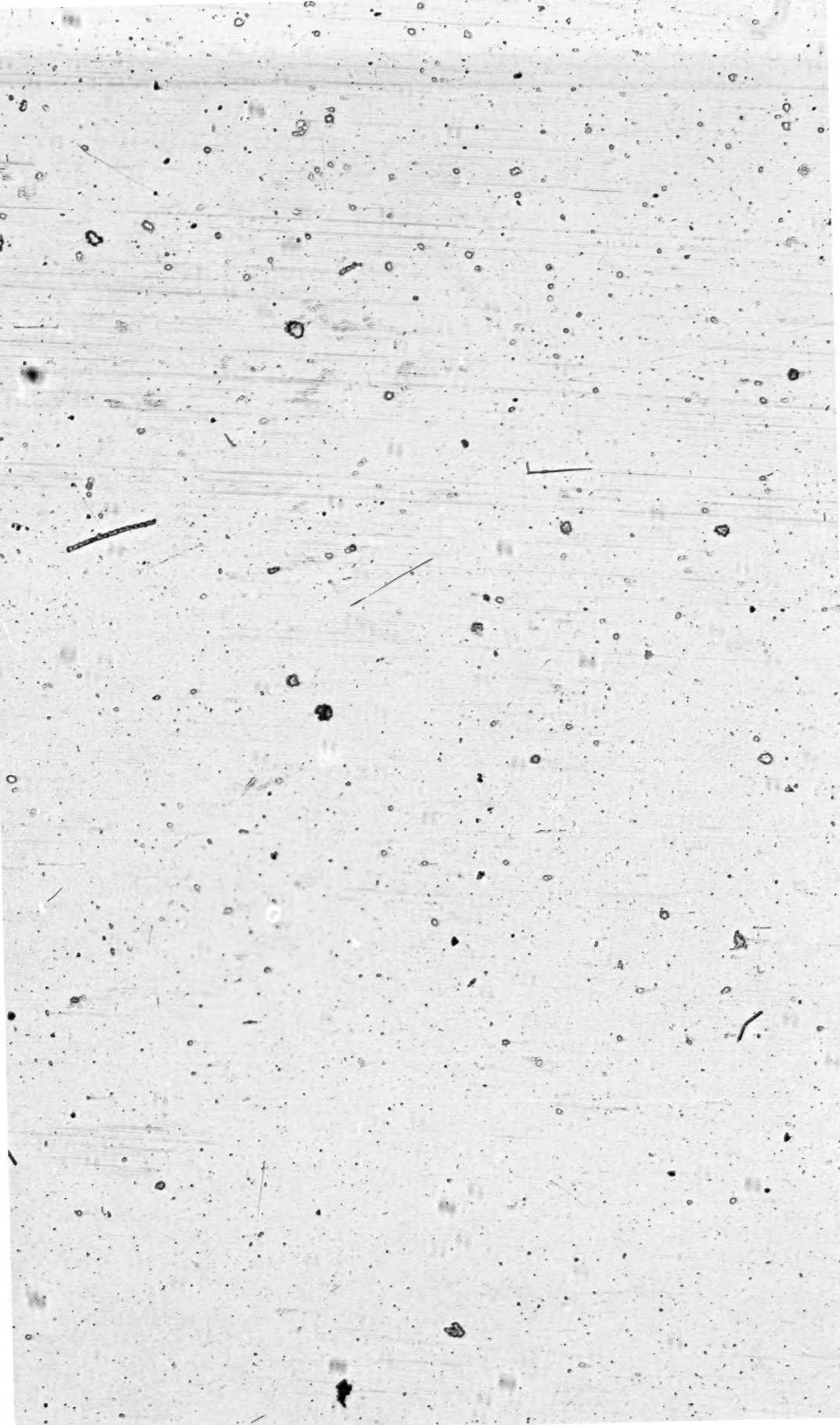
[20] Under the uniform rulings of this Court, such Treasury Regulations must be sustained unless unreasonable and plainly inconsistent with the statute which they interpret; they are not to be overruled except for weighty reasons. *Lykes* v. *United States*, 343 U.S. 118; *Commissioner* v. *South Texas Co.*, 333 U.S. 496; *Commissioner* v. *Wheeler*, 324 U.S. 542; *Helvering* v. *Wilshire Oil Co.*, 308 U.S. 90; *Fawcus Machine Co.* v. *United States*, 282 U.S. 375; *Brewster* v. *Gage*, 280 U.S. 327; *Boske* v. *Comingore*, 177 U.S. 459.

uncontradicted evidence in this case permits but one conclusion, namely, that in the case of that option also the taxpayer received a gain which was in the nature of compensation.

E. *The amount of compensation involved.*

If this Court agrees with the Commissioner that the taxpayer received compensatory income, there remains for consideration an alternative allegation, raised by the taxpayer's petition in the Tax Court and urged by him in the Court of Appeals. That is, the taxpayer argued that if the Commissioner was correct in determining that taxable gain was received, he erred in measuring the gain as of the time the stock was paid for in cash and the stock certificates delivered, it being contended, in effect, that the options were actually exercised (and the gain was to be measured at that time) when the taxpayer gave promissory notes equal to the option price of the stock.

We believe, in view of what was decided in *Commissioner* v. *Smith*, 324 U.S. 177, on the denial of rehearing, 324 U.S. 695, that the Commissioner made a correct determination concerning the time when the options were exercised. However, in view of the fact that the lower courts did not reach this additional issue, it would seem appropriate for the case to be remanded to the Tax Court in order that it may have an opportunity of passing on this question.



CONCLUSION

For the foregoing reasons the judgment of the court below should be reversed.

Respectfully submitted,

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January, 1956.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1956 . 871491 . 810

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No. 873

In the Supreme Court of the United States

OCTOBER TERM, 1955

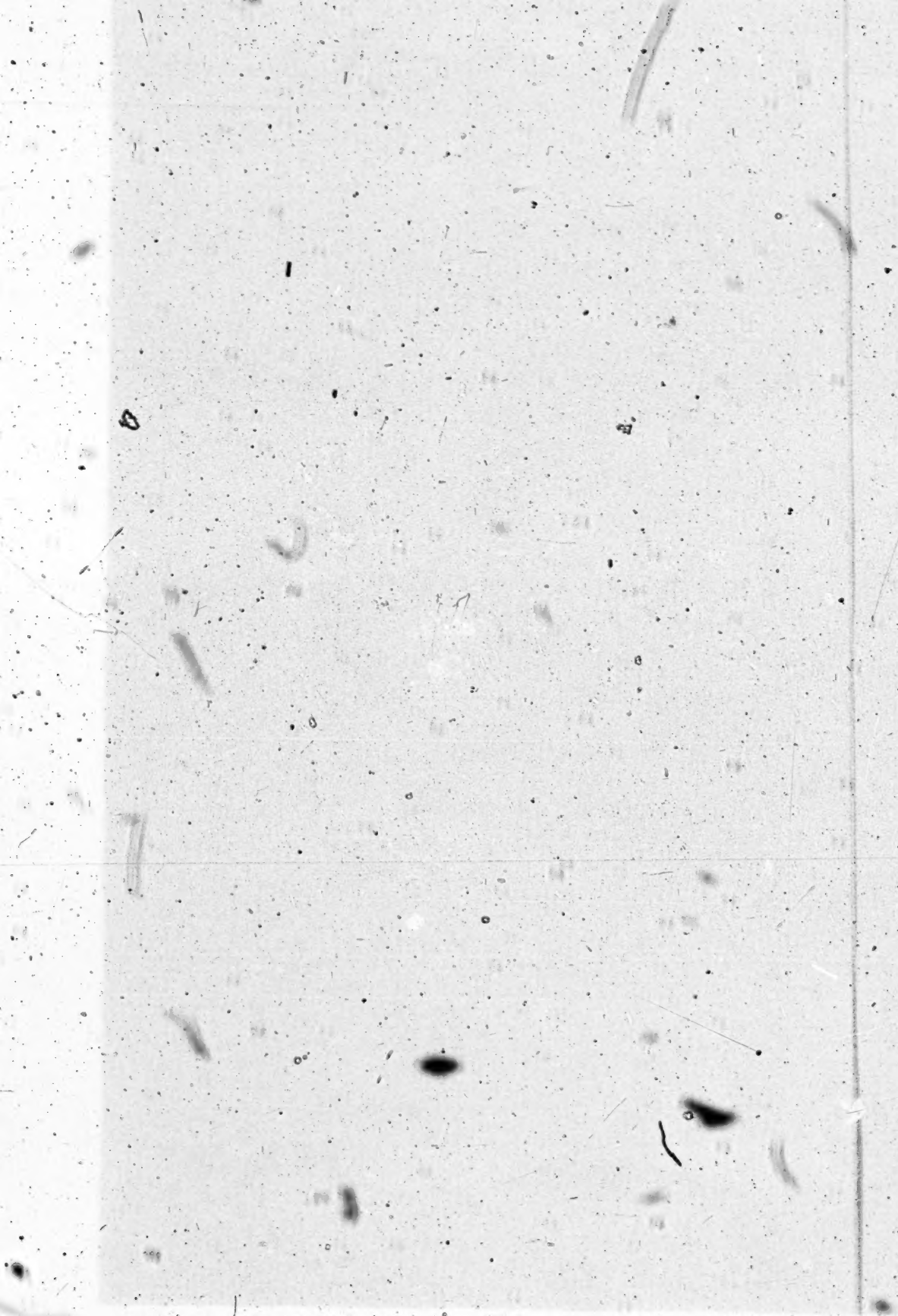
COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILIP J. LOBUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF FOR THE PETITIONER



In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 373

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILIP J. LOBUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF FOR THE PETITIONER

PRELIMINARY

It was pointed out in our main brief (p. 29) that, contrary to the taxpayer's suggestion (Br. 10–14), the Commissioner does not take issue with the underlying facts found by the courts below, but rather challenges only the ultimate conclusion drawn from those facts and the test which was applied in reaching that conclusion. It is not disputed that the ultimate conclusion of the courts below that the taxpayer did not receive taxable income in the nature of compensation was based on application of the so-called "proprietary in-

terest" test.[1] It was also noted in our opening brief (pp. 34–35) that, under such test as applied by the courts below, the immediate economic benefit or gain which the employee receives from his corporate employer through the medium of an employee stock option is held not to constitute taxable income in the nature of compensation only if and when it is found that the employer intended the employee to acquire a proprietary interest in its business. Thus, the finding that the employer intended the employee to acquire a proprietary interest is treated as the decisive factor leading to the conclusion that no compensation is involved, and not, as taxpayer seems to argue (Br. 6–7, 24–25), an inconsequential determination made after the conclusion that no compensation is involved has already been reached. It was further shown in our opening brief (pp. 40–44) that, contrary to taxpayer's argument (Br. 6–7, 24–25), the possession of a proprietary interest on the part of

[1] See R. 146, 160. This test, as the Tax Court defines it, is a principle of law "that upon exercise of such an [employee stock] option the difference between the option price and the market value at the time of the exercise and receipt of the stock constitutes taxable income to the employee at that time if the option was given as compensation * * * but not if it was given to assist him in acquiring a proprietary interest * * *." *Rosenberg* v. *Commissioner*, 20 T. C. 5, 9. It will be noted that compensation as well as a proprietary interest is thus referred to as being "given," making it clear, notwithstanding any implication by the taxpayer to the contrary (Br. 28–29), that in such a context the term "given" is not used to connote a transfer for no consideration.

its employee is never the corporation's sole and final objective precluding any intention to compensate, because, as a practical matter, the corporation does not seek and pay for its employee's acquisition of such an abstract interest as an end in itself, but rather as a means to an end, the end being the concrete reflection of that interest in the services rendered by the employee.

The taxpayer contends that since the early 1930's, the courts have consistently approved the "proprietary interest vs. compensation for services" rule in stock option cases (Br. 6), and that the current Treasury Regulations dealing with such options represent a reversal of prior Regulations without any authority for such a change (Br. 18). The taxpayer also contends (Br. 27) that there is no basis for the Commissioner's argument that the "proprietary interest" test adopted by the courts below would defeat the purpose of Congress in enacting the "restricted stock option" provisions contained in Section 130A of the Internal Revenue Code of 1939 and Section 421 of the Internal Revenue Code of 1954.[2] These contentions would appear to warrant a brief discussion of (1) the judicial and

[2] A further question now raised by the taxpayer for the first time (Br. 2, 5, 29–30)—whether any compensation involved was received and to be measured when the options were granted rather than when they were exercised—is not in this case, since in the proceedings below no such issue was raised (R. 5), or treated as raised, by the pleadings. As pointed out in our opening brief (p. 46), however, there is

regulatory treatment of employee stock options in the past, and (2) the legislative treatment of "restricted stock options" for the future.

JUDICIAL AND REGULATORY TREATMENT OF EMPLOYEE STOCK OPTIONS

With rare exceptions, the cases holding employee stock options to be non-compensatory have involved situations where there was *no* substantial spread between option price and the value of the stock at the time when the option was granted. In these cases the lower courts have offered two principal explanations, one of which—until it was repudiated by this Court in *Commissioner* v. *Smith*, 324 U. S. 177, rehearing denied, 324 U. S. 695—was for a time reflected in the Treasury Regulations dealing with the subject. Under the first or "bargain purchase" explanation, it was held that, on exercising an employee stock option in such a situation, the employee would not receive taxable income in the nature of compensation since he had merely made a bargain purchase. Under the second or "proprietary interest" explanation, which has been previously discussed, some courts (in cases decided prior to *Commis-*

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the further question of when the taxpayer exercised the first two of the three stock options he received—on May 1, 1945, and January 3, 1946, when he gave the corporation his promissory notes payable on March 1, 1947, or on May 24, 1946, when he paid the two notes and received the stock. That question, not reached by the courts below, will be open on remand if the judgment is reversed.

sioner v. *Smith, supra*) adopted a different approach and, instead of stressing the bargain purchase aspect, relied on the employer's desire to grant a proprietary interest as the reason why compensatory income had not been received. The development of these theories and of the applicable Treasury Regulations may be sketched as follows:

From 1923 until 1939, the governing Regulations contained language substantially identical with that set forth in Article 22 (a)–1, Treasury Regulations 94, promulgated under the Revenue Act of 1936, as follows:

> If property is transferred by * * * an employer to an employee, for an amount substantially less than its fair market value, * * * such employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value.

See T. D. 3435, II–1 Cum. Bull. 50 (1923); Article 31, Treasury Regulations 65 and 69, promulgated under the Revenue Acts of 1924 and 1926; Article 51, Treasury Regulations 74 and 77, promulgated under the Revenue Acts of 1928 and 1932; Article 22(a)–1, Treasury Regulations 86, promulgated under the Revenue Act of 1934. Application of these Regulations was not challenged in any case which merely involved acceptance by an employee of a simple offer by his employer to sell him property at a price substantially less than fair market value. In any such case the employer was

free to withdraw his offer at any time prior to its acceptance and it was not questioned that the economic benefit conferred on the employee under those circumstances was intended as compensation. For some time, however, the compensatory character of the economic benefit conferred on the employee was not deemed so clear in the situation where the property was acquired by the employee through the exercise of an option which had become binding on the employer at a time when the option price was not definitely favorable to the employee, i. e., when the option price was not substantially lower than the market price of the optioned property. Accordingly, prior to this Court's decision in *Commissioner* v. *Smith, supra,* a number of decisions had held that in such a situation the employee did not realize taxable income in the form of compensation but merely made a bargain purchase. *Bothwell* v. *Commissioner,* 77 F. 2d 35, 37–38 (C. A. 10th); *Rossheim* v. *Commissioner,* 92 F. 2d 247, 249 (C. A. 3d); *Merhengood Corp.* v. *Helvering,* 89 F. 2d 972, 976 (C. A. D. C.), certiorari denied, 302 U. S. 714; *Evans* v. *Commissioner,* 38 B. T. A. 1406, 1412. These decisions did not take into account that the employer must have realized that his employee, not being bound to exercise the option, would normally exercise it only when it was to his economic benefit to do so. Overlooking that fact, these decisions made no attempt to explain why the corporation was willing to confer such an

economic benefit on its employee as distinguished from anyone else.

In 1939, the Commissioner published his acquiescence in the *Evans* decision. 1939–1 Cum. Bull. 11. At the same time T. D. 4879, 1939–1 Cum. Bull. 159, amended Article 22(a)–1, Treasury Regulations 86 and 94, *supra,* to provide that the difference between fair market value and the price actually paid by the employee should be included in income "to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered." This language was continued in subsequent Regulations: Article 22(a)–1, Treasury Regulations 101, promulgated under the Revenue Act of 1938; Section 19.22(a)–1, Treasury Regulations 103, and Section 29.22(a)–1, Treasury Regulations 111, both promulgated under the Internal Revenue Code of 1939. The Regulations, as so amended, implicitly assumed that there might be a situation, such as that where the option price was the same as or more than the fair market value of the stock when the option was issued, in which the employee, upon being permitted to purchase property from his employer for less than its fair market value could receive an economic benefit from such a "bargain purchase" not in the nature of compensation.

Apparently in attempting to explain why an employer might confer a non-compensatory economic benefit on his employee through the medium of an

employee stock option, a number of decisions—of which those cited in our opening brief (p. 34) are typical—held that such options were not compensatory because they were intended to enable the employee to acquire a proprietary interest. And, although many factors were considered in determining whether particular options were "compensatory" or "proprietary," in nearly all of the cases decided prior to *Commissioner* v. *Smith, supra,* the option was held to be "compensatory" where the market price was substantially in excess of the option price at the time the option was granted to the employee; but where the market price was not substantially in excess of the option price at that time, the option was held to be "proprietary." See Boland, *Employee Options Under the Federal Income Tax,* 28 Taxes 415, 416–417 (1950); Lyon, *Employee Stock Options Under the Revenue Act of 1950,* 51 Columbia L. Rev. 1, 7–8 (1951). Prior to *Commissioner* v. *Smith, supra,* therefore, the principal criterion for determining whether particular stock options were "compensatory" or "proprietary" was the existence or lack of a substantial spread between the option price and market value of the stock when the option was issued.

In 1945, however, this Court's decision in the *Smith* case established, contrary to the argument of the taxpayer in that case, that an employee *could* receive taxable income in the nature of compensation upon making a bargain purchase

through the medium of a stock option even though the market value of the stock did not exceed the option price when the option was issued. Thereafter, any ambiguity in the Regulations was removed by T. D. 5507, 1946–1 Cum. Bull. 18, which, effective with respect to options granted to employees subsequent to February 26, 1945 (the date of the *Smith* decision) amended Section 29.22(a)–1, Treasury Regulations 111, *supra,* to provide that on a transfer of property from an employer to an employee "for an amount less than its fair market value, * * * the difference between the amount paid for the property and the amount of its fair market value is in the nature of compensation and shall be included in the gross income of the employee." By T. D. 5507, the current Regulations were thus brought into conformity with the original Regulations interpreting the statutory definition of gross income.

To summarize this history—prior to T. D. 5507, the proprietary interest explanation was employed principally in cases where, unlike the present one, there was *no* substantial spread between option price and market value when the option was issued or extended. It was only in a few recent cases decided after T. D. 5507 that some courts (with respect to tax years antedating T. D. 5507) employed the "proprietary interest" rationale to hold that there was no compensation even where there was an initial spread.

See *Commissioner* v. *Bradner*, 209 F. 2d 956 (C. A. 6th); *Commissioner* v. *Straus*, 208 F. 2d 325 (C. A. 7th); *Hazleton* v. *Commissioner*, decided April 15, 1953 (1953 P–H T. C. Memorandum Decisions, par. 53,123), appeal dismissed pursuant to stipulation October 19, 1953.[3] Although the issue was not considered ripe for certiorari, the Commissioner consistently adhered to the view that compensation was received by employees in such situations. The case at bar, in which, as pointed out in our opening brief (p. 29), the market value of the stock substantially exceeded the option price both when the options were issued and when they were exercised, is the first one holding under the current Regulations that an employee does not receive taxable income in the nature of compensation through the medium of an employee stock option *if* his

[3] It may be noted that the court which decided the *Straus* case has recently recognized that there is no inconsistency between acquiring a proprietary interest and the receipt of compensation. Thus, the Seventh Circuit in *MacDonald* v. *Commissioner*, decided February 13, 1956 (1956 C. C. H., par. 9284), stated:

> This result [is] not inconsistent with the policy of Household [the employer] in requiring its executive officials to acquire a proprietary interest in the corporation. Taxpayer, like all stockholders of the corporation, acquired such an interest; in fact, the option in connection with the employment agreement served a twofold purpose, that is, it enabled taxpayer to acquire a proprietary interest and at the same time to receive compensation in addition to that which was otherwise provided.

corporate employer intended him to acquire a proprietary interest in its business.

In reaching that conclusion, the Tax Court observed (R. 147) that the Regulations, as amended by T. D. 5507, were not supported by the language of the *Smith* case. This observation confuses the occasion of the amendment in the Regulations with the authority for those Regulations as so amended.[4] The *Smith* case was the occasion of the amendment because it repudiated the "bargain purchase" theory that an employee could not receive taxable income in the nature of compensation upon making a bargain purchase through the exercise of an employee stock option if the market value of the stock did not exceed the option price when the option was issued. The Regulations as so amended, however, like the original Regulations with which they conform, do not depend for their validity solely on the precise holding in the *Smith* case.[5] The authority for the Regulations rests on the broad statutory provisions which they are designed to interpret.

[4] A similar misapprehension was apparently shared by the Senate Finance Committee in the 81st Congress. S. Rep. No. 2375, 81st Cong., 2d Sess., p. 59 (1950–2 Cum. Bull. 483, 526).

[5] Mr. Chief Justice Stone's opinion for the Court in the *Smith* case expressly recognized the comprehensive scope of the statutory definition of income: "Section 22 (a) of the Revenue Act is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected." (324 U. S. 177, 181.) To the same effect are the cases cited in our main brief, p. 25.

It has been demonstrated in our opening brief that those Regulations correctly interpret the provisions of Section 22(a) of the Internal Revenue Code of 1939, and that the "proprietary interest" theory has no proper place in that interpretation.

LEGISLATIVE TREATMENT OF "RESTRICTED STOCK OPTIONS"

There remains to be considered the taxpayer's contention (Br. 27) that there is no basis for the argument in our opening brief (pp. 37–39) that adoption of the "proprietary interest" theory of the courts below would defeat the purpose of Congress in enacting the restricted stock option provisions contained in Section 130A of the Internal Revenue Code of 1939 and Section 421 of the Internal Revenue Code of 1954. The taxpayer apparently does not dispute the fact that, when Congress in 1950 added Section 130A to the Internal Revenue Code of 1939, it sought to grant to the so-called "restricted stock option" more preferential tax treatment than that afforded employee stock options generally under the current Regulations. This fact is made clear in the following statements made by the Senate Finance Committee in favorably reporting the bill containing the provisions enacted as Section 130A (S. Rep. No. 2375, 81st Cong., 2d Sess., pp. 59–60 (1950–2 Cum. Bull. 483, 526)):

> The rule applied under existing regulations is that an employee exercising an option to purchase stock from his employer

> corporation receives taxable income at the time the option is exercised to the extent of the difference between the market value of the stock at the time of exercise and the option (or purchase) price. * * * .
>
> Under your committee's bill no tax will be imposed at the time of exercise of a "restricted stock option" or at the time the option is granted and the gain realized by the sale of the stock acquired through the exercise of the option will be taxed as a long-term capital gain. * * *

Moreover, it is also clear from the statements made by the Senate Finance Committee in this report, including the very portion which taxpayer quotes (Br. 27), that Congress intended that this preferential tax treatment would be received only by those employee stock options meeting the qualifications and safeguards required of "restricted stock options". These statements further show that the options which Congress regarded as "true incentive" devices "rather than compensation" were only those qualifying as "restricted stock options", i. e., where the option price "approximates the fair market value of the stock at the time the option is granted", so that the option will acquire substantial value only if a favorable spread is developed between the market value of the stock and the option price, thus giving the employee an incentive to give his best efforts in the service of his employer. Accordingly, there is no basis for the taxpayer's

suggestion (Br. 27) that Congress believed that non-restricted "proprietary" options, where the spread already exists, as in this case, were also to be treated as incentive devices involving no element of compensation. Thus, following the above-quoted explanation of the preferential tax treatment to be granted, the Senate Finance Committee report stated (S. Rep. No. 2375, 81st Cong., 2d Sess., p. 60 (1950–2 Cum. Bull. 483, 526–527)):

> Such [favorable] treatment is limited to the "restricted stock option" for the purpose of excluding cases where the option is not a true incentive device. Options which do not qualify as "restricted stock options" will continue to be taxed as under existing law.
>
> Ordinarily when an option is issued as an incentive device, the option price approximates the fair market value of the stock at the time the option is granted.
>
> * * * * *
>
> Since the options which qualify for special treatment are regarded as incentive devices rather than compensation, no deduction is allowed the corporation under section 23 (a) with respect to a transfer of stock pursuant to a restricted stock option.

As pointed out in our opening brief (pp. 37–39), however, under the "proprietary interest" rule applied by the courts below, employee stock options which, like those in the case at bar, do not meet the statutory qualifications and safeguards

required of "restricted stock options" would receive even more favorable tax treatment than the "restricted stock options" themselves, thus clearly defeating the purpose of Congress in enacting the "restricted stock option" provisions.

In the final analysis, if a corporation were to transfer shares of its stock to an employee without requiring any payment, it could scarcely be contended (absent a true gift) that the gain received by the employee was not taxable as income simply because the employer desired him to own a stock interest. Clearly, the situation is no different where, as here, the employee is required to pay part, but not all, of the value of the shares of stock.

The decisive inquiry, as numerous cases in this Court hold, is whether the benefit realized by the employee was a gift. *Old Colony Trust Co.* v. *Commissioner*, 279 U. S. 716, 729–730; *Bogardus* v. *Commissioner*, 302 U. S. 34, 39–44; cf. *Commissioner* v. *Jacobson*, 336 U. S. 28, 47–52; *Robertson* v. *United States*, 343 U. S. 711, 713–714; *Commissioner* v. *Glenshaw Glass Co.*, 348 U. S. 426, 432. The triers of the facts should have asked questions like these: Were the options given as an act of "spontaneous generosity"? (*Bogardus*, p. 42.) Is this a case where something was given "for nothing"? (*Jacobson*, pp. 49–51.) Was the employer motivated solely by "affection, respect,

admiration, charity or like impulses"? (*Robertson*, p. 714.) Or, on the other hand, was the employer "interested in its success and in the maintenance of the good will and loyalty of its employees" and did it anticipate a benefit "beyond the satisfaction which flows from the performance of a generous act"? (*Bogardus*, p. 41.)

Had those questions been asked by the triers of the facts, this case would not be here. Review and reversal are required because the lower courts, by asking the wrong question (was this "compensatory" or "proprietary"?), reached the wrong answer.

CONCLUSION

For the reasons stated in our main brief and here, it is respectfully submitted that the judgment of the court below should be reversed.

Respectfully submitted,

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MARCH 1956.

U. S. GOVERNMENT PRINTING OFFICE: 1956

SUPREME COURT, U.S.

MOTION FILED

Office - Supreme Court, U.S.
FEB 15 1956
HAROLD B. WILLEY, Clerk

IN THE

Supreme Court of the United States

October Term, 1955

No. 373

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v.

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Respondent.

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Petitioner,

v.

PHILIP J. LOBUE,
Respondent.

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE

Comes now RAYMOND G. LOCHIEL, by his undersigned counsel, and respectfully moves this Court for leave to file the attached brief amicus curiae and in support thereof shows as follows:

1. Amicus is petitioner in Docket No. 44273 now pending in the United States Tax Court. That case involves the question of the taxability to him of income arising out of his exercise of stock options granted to him by his corporate employer, that question being controlled by Section 39.22(a)-1(c) of Treasury Regulations 118, as amplified by Treasury Decision 5507 and Income Tax Ruling 3795.

2. Amicus is one of twelve employees of Capital Airlines, Inc. who received options to purchase stock in that corporation pursuant to the same corporate resolution. Amicus' case now pending in the United States Tax Court and the federal income tax returns of several of the other optionees are being held in abeyance by specific arrange-

ment with representatives of the Internal Revenue Service, pending disposition of this case.

3. Counsel are familiar with the legal question involved in this case by virtue of the fact that, with the consent of counsel for both petitioner and respondent here, counsel filed a brief amicus curiae in this case when it was before the United States Court of Appeals for the Third Circuit. With the permission of that Court, counsel likewise participated in oral argument before that Court.

4. Based upon discussions with representatives of the Internal Revenue Service, counsel believes that if this Court should find in this case that the United States Court of Appeals for the Third Circuit was correct in finding that the applicable regulations, cited above, are invalid, amicus' case and those of the other optionees of Capital Airlines, Inc. might be disposed of by administrative settlement without further judicial proceedings.

5. Although there is no difference in principle between the positions of amicus and of respondent here, amicus has not seen respondent's brief and therefore does not know the exact nature of the arguments to be made by respondent in this Court or the extent to which respondent's arguments on the merits might be influenced by the particular facts in this case. Since both petitioner and respondent here are inevitably concerned with the precise facts in this case, counsel suggests that it would be helpful to this Court to have before it a separate brief dealing only with the fundamental legal question of the validity of the applicable regulations and that the proposed brief amicus might well make certain points not apt to be made in respondent's brief.

6. As indicated by the consent herewith filed, counsel for the respondent has consented to the granting of this motion. Counsel for the petitioner has seen fit to with-

hold his consent, citing as one reason, the fact that there might be others interested in filing briefs amici curiae and that if consent were granted there would be no basis for withholding consent from such others. To our knowledge the granting of respondent's consent in the Court of Appeals for the Third Circuit, and the filing of our brief amicus there did not produce any additional requests from other possible amici in that court, of up to this date, in this Court. It is respectfully suggested therefore that there is no adequate grounds for this reason.

WHEREFORE, it is respectfully requested that this Court grant this motion.

Respectfully submitted,

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December 5, 1955

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Re: No. 373 Commissioner of Internal Revenue, Petitioner v. Philip J. LoBue

Dear Mr. Redman:

This is to advise you that you have my consent to file a brief amicus curiae in the above-entitled proceedings now before the Supreme Court of the United States.

Sincerely yours,

/s/ Richard F. Barrett
Counsel for Respondent

RFB:d
AIR MAIL

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IN THE

Supreme Court of the United States

October Term, 1955

No. 373

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

PHILIP J. LOBUE,
Respondent.

BRIEF FOR THE AMICUS CURIAE

QUESTION PRESENTED

Does Section 22(a) of the Internal Revenue Code of 1939 warrant a conclusive presumption that, regardless of all other facts, an employee realizes ordinary income, to the extent of the difference between the option and market prices on the date of exercise, when he exercises an option awarded to him by his corporate employer to purchase stock in the corporation?

SUMMARY OF ARGUMENT

Both the Tax Court and the Court of Appeals for the Third Circuit held in this case that Section 39.22(a)-1(c) of Treasury Regulations 118 is invalid in its conclusive

presumption that without regard for anything else, the exercise of every employee stock option provides additional compensation to the extent of the difference between the option and market prices on the date of exercise. Both courts held also that a finding of additional compensation in the exercise of such an option depends upon all the facts in each case, upon analysis of all relevant factors as they have been developed by the courts without break for 22 years. Amicus urges that these conclusions are correct, that they are supported and required, not only by judicial decision, but also by the history and development of congressional action in the area.

ARGUMENT

Prior to the Revenue Act of 1950, there had been no specific statutory treatment of stock options as such. The governing section was 22(a) which simply provided for the taxation as gross income of all kinds and forms of compensation for services. It is fundamental—and this is where the Commissioner's argument falls before it even gets started—that Section 22(a) does not tell us what constitutes compensation in the first instance. It does not determine whether or not a particular item is compensation. Despite its admittedly broad scope, it does not operate except on something that is income initially. It says simply that if something is compensation, it is to be taxed as such despite the fact that it is in the form of a stock option. Perhaps, save for possible constitutional questions, the statute could have provided that every stock option is compensation taxable as such. But it does not. The current regulations do—and in a manner in which a whole host of cases has said has the effect of creating income where there is none in the first instance. Regardless of the wide purview of Section 22(2), administrative fiat cannot do that.

The Original Regulations and Concurrent Decisions

The first effort to cover stock options (even though not by name) was the administrative amendment in 1923 to the Treasury Department's income tax regulations. Treasury Decision 3435, II-1 Int. Rev. Cum. Bull. 50. Then, as now, the rule was stated in terms of bargain sales of property:

> "Where property is sold . . . by an employer to an employee, for an amount substantially less than its fair market value, . . . such employee *shall* include in gross income the difference between the amount paid for the property and the amount of its fair market value." (italics added)

Despite the existence of this mandatory provision, the courts looked to the particular facts of each case to determine whether or not the grant or exercise of a stock option involved ordinary income to the optionee. They either specifically rejected the regulation,[1] or ignored it[2]—although it would seem clear that to ignore a regulation which by its terms is both applicable and mandatory, is necessarily to reject it. These decisions established the rule that the tax nature of a stock option depended upon the intent of the parties, as determined by all the facts; and that when an examination of all the facts determined that the option was given as compensation, then—and only then—the employee realized ordinary income when he exercised the option, to the extent of the "spread".

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[1] See, e.g., *Charles E. Adams*, 39 BTA 387 (1939); *Herbert H. Springford*, 41 BTA 1001 (1940); *Commissioner* v. *Van Vorst*, 59 F.2d 677 (9th Cir. 1932); *Taplin* v. *Commissioner*, 41 F.2d 454 (6th Cir. 1930); *Hawke* v. *Commissioner*, 109 F.2d 946 (9th Cir. 1940); *Rossheim* v. *Commissioner*, 92 F.2d 247 (3d Cir. 1937).

[2] See, e.g., *Delbert B. Geeseman*, 38 BTA 258 (1938); *Gordon M. Evans*, 38 BTA 1406 (1938).

The 1939 Regulations

In 1939, after the decision in *Geeseman*, 38 BTA 258 (1938), the Internal Revenue Service finally acquiesced. It amended the language quoted above by adding the provision that the spread would be taxable as income "to the extent that such difference is in the nature of . . . compensation for services rendered or to be rendered", Treasury Decision 4879, 1939-1 (Part 1) Int. Rev. Cum. Bull. 159. Between 1939 and the decision by this Court in *Commissioner* v. *Smith*, 324 U.S. 177 (1945) this rule prevailed, as a matter of both judicial and administrative construction.

The Smith Case

In the *Smith* case, taxpayer *admitted*, both in his Tax Court petition and on the witness stand, that the option had been awarded to him as compensation for services rendered; he argued nonetheless that there was no tax until he sold the stock. But the Tax Court found that he realized compensation to the extent of the spread between option and market prices at the time of exercise. The Court of Appeals reversed; it adopted the taxpayer's argument and contrary to a whole host of decisions, held that despite the fact that the option was admittedly compensatory and taxable as such, there was no income realized until the stock was sold. This Court granted certiorari because of a conflict with *Connolly's Estate* v. *Commissioner*, 135 F. 2d 64 (6th Cir. 1943) which was illustrative of the many decisions holding that where the option is compensatory, its exercise produces ordinary income.

The *Smith* case thus never posed the question of whether or not the option involved compensation; *that was conceded at the outset.* The only question in *Smith* was the amount and time of the compensation involved.

(See for example the opinion below, 223 F. 2d at 369). It was on this basis that the Commissioner presented the case to this Court, which held that the Tax Court's finding was supported by the evidence and was proper both under the broad scope of Section 22(a) and the then regulations.

The *Smith* case then is this Court's confirmation of the many decisions holding that only where an option involves compensation in the first instance does it constitute ordinary income, and under the facts of that case, the amount of income was measured by the spread between the option and market prices at the time of exercise.

> "It will be seen that the Smith case does not hold that the exercise of any stock option given to an employee may result in taxable gain to him when exercised even though the option was given to enable him to acquire a proprietary interest in the corporation and not as compensation." (*Commissioner* v. *LoBue*, 223 F.2d at 369)

Thus, the *Smith* case did not change pre-existing law; to the contrary, and in response to the Commissioner's specific contention,[3] it reaffirmed the principle that *only if* compensation is involved, Section 22(a) is broad enough to permit measuring the amount of the income by the option-market price spread at time of exercise. *Commissioner* v. *Straus*, 208 F.2d 325 (7th Cir. 1953); *Donald B. Bradner*, 11 TCM 566 (1952), affd. without opinion, 209 F.2d 956 (6th Cir. 1953); *James C. Hazelton*, 12 TCM 398 (1953). In *Straus* the court rejected the Commissioner's specific argument that *Commissioner* v. *Smith* "authoritatively settles" anything and instead adopted the following analysis of the Tax Court (11 TCM 786, 789):

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[3] Commissioner's brief in *Smith*, pp. 11, 14, 22 and 25.

"Whether income is realized by an officer or employee upon the exercise of an option granted him by his employer for the purchase of its stock at a fixed price is to be determined from the intent and purpose of the employer in the granting of the option. This intent must be determined from all the facts and circumstances surrounding the transaction. If the option be granted as consideration for services rendered, the gain resulting from its exercise represents income subject to tax *Commissioner* v. *Smith*. . . . If the option be granted by the employer not to compensate the officer or employee for services rendered or to be rendered, but to enable him to acquire a proprietary interest in the corporation employing him, the transaction does not result in a realization of income upon the exercise of the option."

The Current Regulations

Despite his own argument in *Smith* that each case depended upon its own facts, the Commissioner apparently interpreted the decision in a totally different light. After that decision he restored to the regulations their original, pre-1939 mandatory presumption of ordinary income. Income Tax Ruling 3795, 1946-1 Int. Rev. Cum. Bull. 15 and Treasury Decision 5507 (Id. at 18). They now provide that the option-market spread "*is* in the nature of compensation and *shall be* included in the gross income of the employee" (italics added). The Commissioner makes no particular point as to the authority for the regulations; presumably he relies upon Section 22(a) itself.[4] If this is so, then nothing had happened—in the

[4] This failure to take any position completes the cycle of the Commissioner's vacillation on the point, a matter of some importance in evaluating the argument that the regulations have long provided anything. As Judge Maris pointed out in his opinion below, the Commissioner had been contending that the current version of the regulations was based on the *Smith* case but he abandoned

law or the cases—to warrant the change (except obviously a change of administrative heart). The conclusive presumption of income restored to the regulations was thus necessarily in conflict with a line of cases unbroken for over 20 years.[5] The regulations were an improper extention of the statute the first time and were treated as such by all the courts.[6] They necessarily suffer from the same fatal defect this time. There is no basis for testing the nature of a stock option by any but the same standards that have been applied uniformly by the courts down through the years.

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that position for the first time in his brief in the Court of Appeals (223 F.2d. at 369). The Tax Court (22 TC at 444) and the Senate Finance Committee considering the enactment of what became Section 130A (1950-2 Cum. Bull. 483, at 526) and the House Ways and Means Committee considering HR 6712 (Report No. 2087, 80th Cong. 2d Sess., p. 4; see *infra*, p. 19) all understood that the regulations were founded on *Smith*. So did every other court which had occasion to comment on the *Smith* decision (see cases cited on pp. 5 and 13) and so did every one of the numerous commentators on the subject. For a partial list see 31 Taxes 735, 737 (Sept. 1953). The reasons for this almost universal misunderstanding are fairly obvious. First the Commissioner fostered the impression by his numerous references to *Smith* in his argument in many cases. Second, there was no other visible "development" in the area which could have prompted the radical change in administrative position.

[5] The original 1923-1939 regulations required that there be a "substantial" spread between option and market prices before the mandatory presumption became operative. Despite that qualification, those regulations were rejected by the courts. The same treatment follows *a fortiori* for the current regulations which are without qualification.

[6] As this Court has said: "Treasury Regulations can add nothing to income as defined by Congress." *M. E. Blatt Co.* v. *U. S.*, 305 U.S. 267, 279 (1938). See also *Campbell* v. *Galeno Chemical Co.*, 281 U.S. 599 (1930).

Proprietary v. Compensatory Options

But the Commissioner maintains that these standards are meaningless; that every one of those cases[7] is wrong—and in effect, each one is wrong in principle, regardless of result, since each one was decided on the basis of its particular facts, whereas according to the Commissioner, no inquiry into the facts is permissible. For the same reason, the Commissioner urges also that his own regulations in existence between 1939 and 1945 were likewise erroneous. In other words the Commissioner is simply making the same argument[8] he advanced in every case involving the years 1923 to 1939 when the original regulations, with the same mandatory presumption of compensation, were in effect—the same argument which was rejected—either specifically or by necessary implication—in every one of those cases. It is the same argument made on the basis of the same statutory provision, with no indication of any kind that in the meantime the meaning of that provision (certainly not its terms) had changed.

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[7] The choice between compensatory v. proprietary options has been made on the basis of an analysis of all the facts on at least one occasion in nine of the eleven Courts of Appeals (the First and Fourth Circuits have apparently never ruled on the question) and in a whole host of Tax Court and District Court decisions. Illustrative of the appellate court decisions are *Choate* v. *Commissioner*, 129 F.2d 684 (2d Cir. 1942); *Rossheim* v. *Commissioner*, supra; *Alger-Sullivan Lumber Co.* v. *Commissioner*, 57 F.2d 3 (5th Cir. 1932); *Bradner* v. *Commissioner*, supra; *McNamara* v. *Commissioner*, 210 F.2d 505 (7th Cir. 1954); *Omaha National Bank* v. *Commissioner*, 75 F.2d 434 (8th Cir. 1935); *Van Dusen* v. *Commissioner*, 166 F. 2d 647 (9th Cir. 1948); *Bothwell* v. *Commissioner*, 77 F.2d 35 (10th Cir. 1935); *Merhengood Corporation* v. *Helvering*, 89 F.2d 972 (D.C. Cir. 1937).

[8] Except in those cases, as when the employer's right to deduction was in issue, where the government argued there was no compensation at all; i.e. precisely contrary to the result it urges here. e.g. *Gardner-Denver Co.* v. *Commissioner*, 75 F.2d 38 (7th Cir. 1935).

These arguments of the Commissioner lead the way to the basic question: are all of the cases wrong? Are they all wrong in looking to all of the facts in each case to determine the tax result of a stock option? Is the Court below wrong in this unequivocal statement (223 F.2d at 369):

> "But we cannot agree that section 22(a) supports the amendment in compelling any economic benefit derived by a corporation's employee from the exercise of a stock option to be treated as compensation and taxable as such regardless of whether or not it was so intended."

The Commissioner, of course, says yes, all this is wrong. He argues that since the option is given to an employee it must be either a gift or compensation; there is no middle ground. Since there is no allegation of gift in these cases the option must therefore be compensatory. The Commissioner goes on to say—as he must—that every court, as well as the government during the years 1939 to 1945, was misled by the erroneous assumption that the corporation's desire to give the optionee the opportunity to acquire a proprietary interest in the corporation necessarily meant that the option was not compensatory. In our view the Commissioner is the one confused or misled. It is not denied that the employee's status as such is relevant; of course, the initial award of the option has something to do with the optionee's employment. But it does not follow that such an option automatically qualifies as compensation taxable as such.

An oft-quoted analysis of this fundamental aspect of the problem appears in *Geeseman*,* (38 BTA at 263):

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* This was the decision in which the Commissioner acquiesced (1937-1 Int. Rev. Cum. Bull. 13) and which prompted the 1939 change which removed the mandatory provision from the regulations.

"To hold that a transaction of the character here involved is a 'bargain' purchase having nothing to do with the employer-employee relationship, or, to the contrary, that it is not a purchase but constitutes the receipt of compensation having nothing to do with the purchase of property, to the extent that the fair market value exceeds the purchase price, is to ignore obvious facts and to assume a case substantially different from the one before us. In the first place, it may not be said that the acquisition of the stock of Continental Can Co. was not a purchase merely because the price paid was substantially lower than the price at which the same stock was then selling on the market, and, in the second place, obvious facts are ignored if it be said that the stock transaction was separate and apart from, or was not based upon, the employer-employee relationship, or that it had no relation to services rendered or to be rendered. In practically all such cases both elements are present and decision is impossible if the absence of one or the other is essential thereto.

"Normally the purchase of property does not result in the realization of taxable gain, but rather in the acquisition of an asset with a view to the later realization of gain or profit through its use or subsequent sale, and upon sale the general rule is that no taxable gain is realized until the seller has recovered his cost or capital . . . Accordingly it is our opinion that as a prerequisite to the conclusion sought by the respondent it should definitely and clearly appear that a transaction, which in form is nothing more than a purchase and to an obvious and substantial extent is unquestionably a purchase, is in fact to some extent the payment of compensation for services rendered or to be rendered."

Perhaps an equally good analysis appears in the Commissioner's own argument to this Court in the *Smith* case. After noting the presumption of compensation that stems from the employer-employee relationship, the Commissioner argued (pp. 11-12 of his brief in the *Smith* case):

> "This may not always be true so far as bargain purchases are concerned. Conceivably such a bargain may occur where an employer can find no other buyer in a stagnant market, or even where the sole purpose is to insure the employee's unflagging loyalty by giving him a stake in the employer's business. [Citing the *Geeseman* and *Adams* cases, *supra*.] If as a matter of fact, however, a transaction constitutes payment of compensation to the employee, its tax consequence cannot be avoided by casting it in the form of a sale."

And again (Id. at 14):

> "In determining whether a particular transaction involves the payment of compensation for personal services, the decisive factor is that of intention . . . This is, of course, a question of fact."

That is precisely our contention here.

But the government apparently now contends that if there is any element of compensation—and there is, says the Commissioner—ipso facto—by virtue of the fact that the optionee is an employee—then nothing else matters. As already indicated, no court has agreed with this analysis; all the cases have examined all the facts and decided accordingly.

Before determining whether or not an option was compensatory, the courts looked to such factors as the spread between the option and market prices on the date the option was granted; whether the option was given as part of an employment contract or in lieu of salary increase; whether the employee could exercise the option only while still working for the corporation; whether the parties regarded the option as a means of enabling the optionee to acquire an interest in the corporate employer; and so on. Thus, where an employee's salary and bonus have been reasonable and adequate in the light of company policy, nature and scope of responsibility and so on, where his work continues unchanged, where

the employer decides it to be in its interest for a key employee to be given the chance to become a stockholder, where neither party is interested in or concerned about compensation, and where therefore that employee is given the option to buy stock at the same price at which that stock is being sold on the market on the day of the grant—these circumstances constitute one illustration where clearly the employee has not been given the option as compensation and therefore does not realize income when he exercises the option.

The regulations prevent such a result; they even bar the relevance of all those facts.[10]

The significant thing is that until all the facts have been examined, the correct answer cannot be determined. Since the Commissioner's regulations bar such an examination, they are invalid.

The Commissioner appears to find further support for his all-or-none position in the local law aspect of stock options. He seems to argue (brief pp. 41-43) that if the options are not granted for services, then they are without consideration and invalid to start with. Once again we urge that the Commissioner is confused.

We have here a federal tax case. We are not confronted with the question of whether a particular state

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[10] Interestingly enough even the Commissioner discusses the facts here. His brief analyzes them (pp. 30-33) for the purpose of showing that they indicate that the option was compensatory. But what difference do any of the facts make under the regulations? As a matter of fact, despite his apparently unequivocal position, in the Court of Appeals, the Commissioner nonetheless limited his argument for the validity of the regulations as they are "applied to the facts of the instant case" (brief, pp. 16, 32). If the Commissioner is right in principle there should be no exceptions. It is our contention that he is wrong in principle, that there are many exceptions, that it requires an analysis of the facts in each case to determine the correct result.

law or rule might invalidate the option. The question of consideration varies at least in degree from state to state. There is in addition no scientific standard for determining the value of the consideration running to the corporation even if it does consist, even in part, of services. Those problems are not applicable. If they were, the stock option area would be one of confusion with different results depending on the particular state law involved. As all the other cases have done, for purposes of the federal tax question involved, this Court is entitled to assume that the option is valid and effective.

Another difficulty with the regulations lies in its conflict with—of all things—the *Smith* case. It will be recalled that this Court said there that it might well be possible for "the option itself, rather than the proceeds of its exercise" (324 U.S. at 182) to represent the compensation.[11] But that result too is not permissible under the regulations. In one instance where the situation imagined by this Court actually materialized, the Court simply ignored the regulations. Without even referring to them, the Court agreed with the Tax Court that the option was, under all the facts, compensatory, but found that the option itself was the intended compensation. *McNamara* v. *Commissioner*, 210 F.2d 505 (7th Cir. 1954). See also *Commissioner* v. *Stone's Estate*, 210 F.2d 33 (3d Cir. 1954).

Once again the significant factor is that the decision was based on the Court's own evaluation of the relevant

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[11] It is of obvious importance to note that this point was specifically urged by the Commissioner in his brief in *Smith*. Thus (p. 24): "This is not to say that compensation can never be received in the form of an option to buy property from the employer, as where the employee is given a valuable option which is intended to constitute in itself the compensation." And again (p. 25): ". . . we do not contend for . . . an inflexible rule that taxable compensation cannot possibly be given in the form of an option . . .".

facts. The decisions avoided the regulations which were both applicable and mandatory in their operation. Clearly, by implication at least, the courts were saying that the regulations were invalid. The Tax Court has "said" the same thing in two cases it has heard since its decision in the instant case. *Bowen*, 13 TCM 668 (1954); *MacDonald*, 23 TC 227 (1954).

Every Economic Benefit Is Not Compensatory

But the Commissioner argues: as long as there is an economic benefit, there is an immediate tax impact, and in view of the employer-employee relationship, that impact takes the form of additional compensation—and therefore ordinary income—to the extent of the spread between option and market prices at the time of exercise; nothing else matters. We contend that this argument proves too much. There are many instances of immediate economic benefit which do not constitute taxable income. There is for one example no immediate tax on the receipt of an economic benefit in the form of a bargain purchase in the absence of the employer-employee relationship. *Palmer* v. *Commissioner*, 302 U. S. 63 (1937). Is the presence of that relationship sufficient, all by itself; and in complete disregard of everything else, to produce the opposite tax result? We urge that it is not; that the tax nature of a transaction can be properly determined only on the basis of an examination of all the relevant facts; that conclusive presumptions in factual matters are dangerous administrative expediencies—perhaps prompted, but not justified, by problems of administration—frequently rejected by the courts. *Heiner* v. *Donnan*, 285 U. S. 312 (1932); *Hoeper* v. *Tax Commission*, 284 U. S. 206 (1931); *Schlesinger* v. *Wisconsin*, 270 U. S. 230 (1926); *Commissioner* v. *Clark*, 202 F.2d 94 (7th Cir. 1953).

Interestingly enough, in a closely analogous situation even the Commissioner has refrained from conclusive presumptions. This relates to bargain purchases by stockholders. The original 1923 version of the regulations bunched into one paragraph the Commissioner's rule for finding ordinary income in the case of every bargain purchase by stockholders and employees—dividend for the former, compensation for the latter. The 1939 change eliminating the conclusive presumption continued the bunching of the two groups. One paragraph provided ordinary income treatment for both depending upon all the facts surrounding the bargain purchase; the spread between purchase price and fair market value was a dividend to the stockholder "to the extent that such difference is in the nature of . . . a distribution of earnings or profits taxable as a dividend"; it was additional compensation to the employee to the extent that it represented compensation. But when the present regulations were adopted in 1945, only the employee rule was changed. Bargain purchases by stockholders continued to be governed by all relevant facts; but similar acquisitions by employees were subjected to the same conclusive presumption which the courts had consistently rejected for 22 years.

Obviously the regulations on bargain purchases by stockholders were controlled by this Court's decision in *Palmer* v. *Commissioner, supra,* that whether a dividend is involved is a question of fact. But why should the rule be any different where the corporation-stockholder relationship is replaced by the employer-employee relationship? If employers "just don't" give options to employees except by way of compensation, corporations "just don't" give stockholders as a class the privilege of a bargain purchase except by way of dividends. The answer in each case is a matter of intention as reflected by all the facts. This Court so held in the *Palmer* case,

again in response to the Commissioner's argument. The same result should apply here.

There is still another approach which demonstrates that the government's argument proves too much. If the receipt by an employee of every economic benefit from his employer represents additional compensation, why are not employees taxable on all such receipts? Why for example is the taxability of the rental value of living quarters occupied by the employee dependent upon all the facts, including the convenience of the employer?[12] Why is that latter factor of any more significance in that connection than in connection with a bargain stock purchase? In the former connection, it is considered relevant because it involves a determination by the employer that the employee cannot do his job or cannot do it well, unless he occupies quarters provided by the employer. To take an extreme case to highlight the analogy, why is the employer's convenience any the less relevant in a situation where company policy requires that all employees at a certain level of responsibility must own a prescribed number of shares of stock in the company and where an employee eligible for promotion to that level is given say six months within which to make his bargain purchase at the fair market value on the date of promotion? Yet the Commissioner's regulation renders all of these matters irrelevant and beyond the scope of the courts' power to inquire.

Why also are employees not taxable on such things as free medical care; free recreational services, such as con-

[12] Section 29.22(a)(3) of Treasury Regulations 111. The Commissioner's effort to minimize the significance of the employer's convenience test has met with the same resistance which the various courts have shown in the stock option area. See for example *Diamond* v. *Sturr*, 221 F.2d 264 (2d Cir. 1955) which contains an interesting discussion of the history of the Commissioner's vacillation on the living quarters question.

certs, movies and athletic programs; discount purchases of the corporation's product on sale to the general public? In every instance, each of the government's tests is satisfied: an economic benefit passing from employer to employee for less than fair market value. Yet no tax is imposed. And for good reason. None of those things is intended as compensation; they are conferred instead as a means of making the employer's place of business a nicer place to work; to build up employee morale and spirit; to create a feeling of friendship between employer and employee, a feeling on the latter's part that his was more than just a job—all designed to inure to the corporation's benefit in the form of better service, more loyal service, less absenteeism, and the like—no different in principle from the corporation's expected benefit from giving a stock option to certain employees.[13]

None of these fringe benefits is taxed as income to the employees receiving the immediate economic benefit from their employers—for the reasons indicated. There is no special reason applicable to just one of those fringe benefits—stock options—which permits, let alone requires, totally different tax treatment. In fact what differences may exist illustrate that the economic gain is more direct, more concrete and less fortuitous in the case of all the fringe benefits listed above other than the stock option. In the latter case, the amount of economic benefit is determined solely by the employee by his decision whether and when to exercise his option; even then he has done no more than make a bargain purchase. In the case of

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[13] See *Peters* v. *Smith*, 221 F.2d 721 (3d Cir. 1955) for a recent example of a "fringe benefit" not taxable as compensation.

An interesting analogy in this connection concerns the unquestioned deductibility of business gifts as ordinary and necessary business expenses on the theory that the donees' good will is important to the corporation's welfare. Such business gifts are not taxed as income to the donees.

the other fringe benefits, the economic benefit is not subject to the employee's control; as just stated, it is direct, concrete and immediate.

If then the existence of the employer-employee relationship does not mean that every economic benefit conferred on the employee is automatically taxable as additional compensation, there is such a thing as a non-compensatory stock option similar to a bargain purchase and therefore without tax incident at the time of receipt or exercise of the option.

As the court below said (223 F.2d at 368):

> "A virtually unbroken line of cases supports the Tax Court in holding that if the grant of a stock option by a corporation to its employee is intended as additional compensation to him the excess of the fair market value over the option price is income taxable to him when the option is exercised, but on the other hand if the grant of the option is intended to provide him with a proprietary interest in the business no taxable gain is recognized when the option is exercised, whether the grant of the option is the one or the other being in every case a question of fact."

Legislative History

We have attempted to show that both as a matter of extensive and consistent judicial precedent and on the merits as a matter of first impression, the Commissioner's regulations go far beyond their permissible scope and are therefore invalid. Since we are talking about the meaning of an underlying statute, it is of obvious significance to attempt to determine Congress' feeling in the matter. Congress has made it very clear that it agrees with our analysis on two of the occasions that it has considered the matter.[14] The first was the abortive

[14] For similar expressions of Congressional opinion see 93 Congressional Record A4320, A4322.

effort in 1948 to enact the first specific provision dealing with stock options. The second was the actual adoption two years later of the new concept of "restricted stock options". It was because Congress thought that the regulations were invalid, that at least as to the future, corrective legislation was necessary in a prescribed area.

In 1948, Section 137 of HR 6712, known as the General Revenue Revision Bill of 1948, proposed to adopt rules covering all options (a result which the Commissioner attempts to achieve through the regulations). HR 6712 not only proposed to deal with restricted stock options, it provided also a "General Rule" as to all other options. That general rule would in effect have adopted the Commissioner's entire position but only with respect to options granted after the date of enactment. Section 137 (f)(1). In other words, the bill (which never became law) purported to cover the entire field of stock options but only as respects those options not then in existence. Presumably, the then existing law would govern all other options, including those exercised after the date of the proposed change.

In proposing Section 137, the House Ways and Means Committee had this to say as to the regulations (Report No. 2087, 80th Cong. 2d Sess., p. 4):

> "At the present time the taxation of these options is governed by regulations which are so severe that in effect they prevent the use of the employee stock option for incentive purposes. Moreover, these regulations constitute an extension of the Supreme Court decision upon which they are based (*Commissioner* v. *Smith* . . .) The resulting uncertainty is an additional reason for congressional action at the present time."

It was with this history in mind that Congress passed the Revenue Act of 1950 adding what is now Section 421 to the Code. But the new section deals only with restricted stock options; it does not include any provisions purporting to establish a general rule.

In these circumstances this question is presented: what is the tax status of employees' stock options granted and exercised at times which satisfy the time requirements of Section 421, but which do not in the first instance qualify as restricted stock options within the statutory definition of that term? Put another way, does Section 421 provide an exclusive rule whereby stock options can avoid ordinary income treatment? Are all other employee stock options automatically, upon their exercise, compensation in the hands of the optionee? If the answer to that question is in the negative, then *a fortiori* there can be no conceivable argument that the spirit or purpose of Section 421 in any way supports the regulations.

That the answer is unequivocally in the negative is clearly indicated both in the background recited above and in the legislative history of Section 421 itself.

As to the latter, the Senate Finance Committee, which first inserted the stock option provisions in the bill (HR 8920) which had already passed the House, stated that the changes were designed to establish "a *new* set of rules for the tax treatment of *certain* employee stock options" (italics added) (1950-2 Int. Rev. Cum. Bull. at 526), and (Ibid.):

> "Moreover, your committee believes these regulations go beyond the decision of the Supreme Court in *Commissioner* v. *Smith.*"

The report states also that "options which do not qualify as 'restricted stock options' will continue to be taxed *as under existing law*" (italics added) (Ibid.); this same point is made elsewhere in the report (Id. at 552). Obviously, the words "existing law" must have meant Section 22(a) as interpreted and applied by the various courts. That means that options which do not qualify as restricted stock options are to be analyzed—on their facts—to determine whether they are proprietary or com-

pensatory—in precisely the same way as before the statute was changed.

As a matter of fact the Committee Report specifically recognizes the distinction between proprietary and compensatory options (Id. at 526):

> "Your committee's bill (section 220) establishes a new set of rules for the tax treatment of certain employee stock options. Such options are frequently used as incentive devices by corporations who wish to attract new management, to convert their officers into 'partners' by giving them a stake in the business, to retain the services of executives who might otherwise leave, or to give their employees generally a more direct interest in the success of the corporation."

That this distinction still exists must follow unless the words "existing law" are read to mean "existing Commissioner's regulations". But such a tortured reading flies squarely in the face of the Committee's own explicit denunciation of the validity of those regulations. Congress could hardly have intended to characterize as existing law the very rule which it said was wrong and which prompted the legislation in the first instance. Furthermore, in the very same paragraph where it used the phrase "existing law", the Committee used the phrase "existing regulations" where it was clear that the reference was to the regulations. This conclusion is further fortified by realization of the fact that, as described above, between the years 1923 and 1939, when the regulations contained in effect the same conclusive presumption of compensation as appears in the current regulations, the "law" was as the various courts determined—not what the regulations said. Under the "law", the courts have the exclusive right to determine whether the option in each particular case was in the nature of compensation—*regardless of what the regulations said.* The

"law" since the *Smith* case is the same.[15]

Certainly this discussion makes it entirely clear that the restricted stock option section did not establish an exclusive rule for the treatment of all employee stock options. If that had been the congressional purpose, it would have been an exceedingly simple thing to do—in exactly the manner proposed in 1948 in HR 6712. There the House stated the general rule to the effect that unless the option was a restricted stock option, it would involve compensation to the extent of the spread in the year of exercise. If HR 6712 had become law, the question might have been foreclosed; the tax status of employee stock options might have been fully determined[16] (except possibly for some constitutional question). But that is not what was said in the Revenue Act of 1950. The act itself provides rules *only* with regard to restricted stock options, and the committee which drafted the provisions stated that all other options are to be determined by "existing law". The committee stated also that "the section contains no rules applicable to transactions respecting stock options which are not 'restricted stock options' as defined in the section" (1950-2 Cum. Bull. at p. 552). Since Congress was once on the verge of laying down an all inclusive rule and did not do so, when it thereafter did enact some provisions which by their terms deal only with certain phases of stock options, the conclusion is inevitable that these provisions have no effect on all

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[15] In addition to the cases already cited, see for example *Babbitt*, 23 TC 850 (1955); *Sorenson*, 22 TC 321 (1954); *Rosenberg*, 20 TC 5 (1953); *Clark*, 9 TCM 719 (1950); *Nicolson*, 13 TC 690 (1949); *Lamond* 5 TCM 51 (1946).

[16] The regulations proceed on the theory that the statute so provided back in 1945. If that is what the statute had said or could reasonably have been interpreted to mean, there was hardly any need for the proposed statutory change in 1948.

other phases of the question. They continue to be governed by existing law as developed by the courts.

The question in each case of non-restricted stock options continues to be whether or not the particular option involves compensation. In other words, the tax status of non-restricted stock options would be exactly the same as it was prior to the passage of the Revenue Act of 1950.

The Commissioner argues that if this is so, then the holder of a restricted stock option fares no better than taxpayers in the position of the respondent here. Once again the Commissioner is confused: Section 421 starts out with the assumption that the options within its scope run the serious risk of being treated as compensatory. It then goes on to provide that if certain potentially compensatory options satisfy certain specifications, then the normal likely result of compensation does not follow. In the absence of Section 421, the options to which it applies would have had to run the gauntlet of the proprietary v. compensatory test and would perhaps have been treated as compensatory; that risk is eliminated.

There is no inconsistency. The Commissioner is wrong in his argument that congressional purpose is being stultified.[17]

Summarizing, by the adoption of section 130A in 1950 Congress in effect said:

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[17] He contends further (brief p. 39) that the Congressional purpose is further thwarted by the loss of revenue arising out of the applicability of capital gains tax to the gain and the complete elimination of any ordinary income. The Commissioner overlooks the fact that if ordinary income is involved for the optionee, the corporation gets a corresponding off-setting deduction from ordinary income. There is no corporate deduction where only capital gains apply.

1. The law has been consistent and clear for a long time, that there is a distinction between compensatory and proprietary stock options, and that the real nature of a particular option depends upon the relevant facts.

2. *Commissioner v. Smith* did not change the law.

3. Existing regulations are therefore invalid and have created needless uncertainty and litigation.

4. Since the regulations apply only to options granted after the date of the *Smith* decision (February 26, 1945), we are concerned only with such options. Even as to them, if they were exercised after 1949, we do not establish any all-inclusive rule. Instead we do just two things.

5. First, we adopt the concept of the "restricted stock option" with specified tax results, in order to avoid the question of fact (proprietary v. compensatory) in a prescribed area.[13]

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[13] Cf. *Helvering* v. *Clifford*, 309 US 331 (1940) where taxpayer had argued that Sections 166 and 167 (dealing with the taxability of income of certain short term trusts to their grantors) constituted the exclusive method of producing that result, so that the income of trusts outside of those two sections could not by any other means be taxed to their grantors. But this Court rejected that argument and said (at 337-338):

> "In view of the broad and sweeping language of § 22(a), a specific provision covering short term trusts might well do no more than to carve out of § 22(a) a defined group of cases to which a rule of thumb would be applied. The failure of Congress to adopt any such rule of thumb for that type of trust must be taken to do no more than to leave to the triers of fact the initial determination of whether or not on the facts of each case the grantor remains the owner for purposes of § 22(a)."

So here: the adoption of Section 130A has the effect only of carving out of Section 22(a) a defined group of employee stock option cases to which specified tax results would be applied. But all other employee stock option cases were not carved out; they remained subject to analysis for the purpose of determining whether or

6. Second, as to all other options, they are to be tested by the standards announced by the various court decisions. This includes options issued prior to the effective date of the 1950 change, regardless of what they say, as well as options issued after that date if they do not qualify as restricted stock options. *As to all those other options*, it continues to be a question of fact in each case.

We cannot see how this congressional action—reviewed against the background of what Congress failed to do two years earlier—provides the slightest support for the regulations or for any conclusive presumption of the fact of compensation in every case. To the contrary, this congressional action requires precisely the opposite result.

In view of the Commissioner's own vacillation on the point, the Court's disregard and rejection of the conclusive presumption in the original regulations, and Congress' own clear expression of opinion that the current conclusive presumption is unwarranted, it is little short of amazing for the Commissioner to argue—even in only a footnote (note 20, p. 45)—that the regulations are entitled to substantial weight. The argument becomes even more amazing when viewed in light of the Commissioner's somewhat different contention before this Court in his brief (p. 22) in the *Smith* case where he was talking about the earlier version of the regulations which handled each case on its own facts.

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not they are compensatory. Just as the enactment of Sections 166 and 167 did not affect the taxability under Section 22(a) of trusts which did not qualify under the amendments, so the passage of Section 130A is not in any way determinative of the tax status of stock options which are beyond the scope of that section. In other words, as the Senate Finance Committee report said, such options are to be treated under existing law without regard to 130A.

"The governing Treasury Regulations providing that where property is transferred by an employer to an employee for an amount substantially less than its fair market value, the employee shall include the difference in his gross income *to the extent that it is in the nature of compensation* for services, expresses well settled principles, is of long standing, and must be deemed to have Congressional approval" (italics added).

CONCLUSION

The conclusion is inevitable that the regulations represent the Commissioner's attempt to reverse the whole host of cases which determine the tax nature of employee stock options on the basis of the particular facts in each case. The conclusion is inescapable that, without the benefit of any statutory or judicial change, the Commissioner has, by administrative fiat, attempted to legislate out of existence the distinction between proprietary and compensatory stock options which the courts consistently developed over the years and which in fact started at a time when the original version of the regulations said that there was no such distinction. The Commissioner has by administrative fiat attempted to create income where in fact there is none. Congress has never said that every stock option involved compensation taxable as such. Legislative history clearly requires the conclusion that congressional opinion is precisely to the contrary.

We respectfully urge this Court to affirm the decisions below that Section 39.22(a)-1(c) of Treasury Regulations 118 is invalid and that the tax nature of employee

stock options is to be determined by the facts in each case.

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FILED
JUL 5 1966
JOHN F. DAVIS, Clerk

No. 375

SUPREME COURT OF THE UNITED STATES

October Term, 1965

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

PETER P. LARKIN,

Respondent.

BRIEF

Supreme Court of the United States

OCTOBER TERM, 1955.

No. 373

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER,

v.

PHILIP J. LoBUE.

PETITION FOR REHEARING

Judgment in the above-entitled proceedings was entered May 28, 1956. Motion of the respondent to enlarge the time within which petition for rehearing might be filed to July 6, 1956 was granted by order dated June 15, 1956.

The respondent herewith petitions for rehearing on the following grounds.

1. *The decision is based upon misstatements of fact as to critical and pivotal points.*

a. The Opinion states "LoBue and a number of other employees were notified that they had been tentatively chosen to be recipients of nontransferable stock options *contingent upon their continued employment.*" (Emphasis

supplied—Op. p. 1).[1] The Opinion states "These three options were not transferable and LoBue's right to buy stock under them was *contingent upon his remaining an employee of the company until they were exercised.*" (Emphasis supplied. Op. p. 6).

The record provides no basis whatsoever for these statements that the taxpayer's right to exercise the options was contingent upon his remaining an employee. The only requirement for continued employment related to the first option issued January 18, 1945, and this requirement was merely that he remain employed to June 30, 1945 to comply with requirements of the Michigan Corporation and Securities Commission. (Exs. 3-C, 4-D, 5-E, 6-F, 7-G; R. 17-24; R. 143-145.) See also the Opinion of Mr. Justice Harlan. Subject to the June 30, 1945 requirement with respect to the first option, the taxpayer could have left his employment the day after receiving each option, without affecting its exercisability.

b. The Opinion states "The Tax Court held there was no taxable income, however, on the ground that *one* purpose of the employer was to confer a 'proprietary interest'." (Emphasis supplied—Op. p. 4).

The Tax Court did not state that to confer a proprietary interest was only *one* of the purposes of the options, but categorically stated that the *single* purpose of the options was the proprietary interest purpose—that they were not to any extent conferred as additional compensation (R. 146, Findings of Fact). The Tax Court stated its conception of the test it was applying as follows: "Determination of whether a stock option is granted to an employee as additional compensation, or to give him a proprietary interest in the Corporation, thus remains a question of fact. In

[1] References herein to the Opinion are made by the abbreviation "Op."

reaching that conclusion, we think the criteria set forth by this Court in *Delbert B. Geeseman*, 38 B.T.A. 258 (1938), is still the most reliable guide to be followed. In the *Geeseman* case, we said, at page 264:

> • • • *as a prerequisite to the conclusion sought by the respondent* it should definitely and clearly appear that a transaction, which in form is nothing more than a purchase and to an obvious and substantial extent is unquestionably a purchase, *is in fact to some extent* the payment of compensation for services rendered or to be rendered.

Here it 'definitely and clearly' appears that the granting of the options to petitioner in 1945, 1946, and 1947 was not intended as additional compensation for his services." (Emphasis supplied—R. 148).

This is as clear a statement as possible that there must be no purpose whatsoever to compensate, but only the single purpose to permit acquisition of stock.

The statement of the Tax Court referred to in footnote 5 of the Opinion is misleading, being itself inaccurate as to what was said in *Geeseman*, 38 B.T.A. 258. *Geeseman* does not refer to the element of "additional compensation" being present. It merely states at p. 263 that it is obvious that the elements of purchase and the employer-employee relationship are both present in every case of this type. But it is completely clear that both *Geeseman* and the Tax Court below state as the rule to be followed that the Commissioner prevails if the transaction is *to any extent* payment of compensation for services.[2]

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[2] Although impertinent to the main Opinion, the Concurring Opinion of Mr. Justice Frankfurter and Mr. Justice Clark states that the time when the taxpayer should be taxed was not in issue in either court below. On the contrary, this issue was stated as an issue and argued in the taxpayer's briefs in both courts.

2. *The decision is in direct conflict with established rules of procedure.*

This Court has defined its jurisdiction as excluding review of concurrent findings of fact by two courts below, other than in exceptional constitutional and public cases. This precedent for the guidance of litigants is precisely stated in *Graver Tank & Mfg. Co.* v. *Linde Air Prod. Co.*, 336 U.S. 271 (1948), at page 275, as follows:

> " * * * A court of law, such as this Court is, rather than a court for correction of errors in fact finding, cannot undertake to review concurrent findings of fact by two courts below in the absence of a *very obvious and exceptional showing of error.* * * * " (Emphasis supplied).

See also Rule 52(a), Federal Rules of Civil Procedure; *Great Atlantic & Pacific Tea Co.* v. *Supermarket Equipment Corp.*, 340 U.S. 147; *United States* v. *Appalachian Electric Power Co.*, 311 U.S. 377; Moore's Federal Practice par. 52.12 and cases cited therein.

The case at hand turns on a pure question of fact: were the options given as compensation for service? Without an affirmative determination Section 22(a) has no application. Both courts below concurred, on the basis of extensive stipulated, documentary and oral testimony, that the options were not given to any extent as such compensation. No *very* obvious and exceptional error (or even obvious and exceptional error) was argued or shown by the Commissioner, and the Opinion makes no reference to any obtuse fact finding below.

The Court by finding the fact, essential to its decision, that the options were given as compensation for services has departed sharply from established procedural rules and

precedent, and contrary to its own announced jurisdiction has assumed the function of a court for correction of errors in fact finding rather than one of law.

3. *The decision is contrary to all judicial precedent, including decisions of this Court.*

The Opinion is unique in not citing a single case supporting the decision on the issue involved. It states at page 3 "Disputes over the taxability of stock option transactions such as this are longstanding.", citing three cases. The disputes have not been in the courts—every court which has dealt with the issue has without exception applied the same rule that employee options result in purchase transactions if not given as compensation. The three cases cited are in strict accord with this view.

Commissioner v. *Smith*, 324 U.S. 177, cited in the Opinion merely held that *if* a stock option is given "as compensation" the employee is taxable, tacitly acknowledging that in the absence of such essential fact a purchase is made.

Palmer v. *Commissioner*, 302 U.S. 63, dealt with at length in the taxpayer's brief as supporting his position, is cited in the Opinion for the proposition that an arm's length purchase of property at a bargain price gives rise to no taxable gain. It is then distinguished from the present case on the grounds that the taxpayer here was not dealing at arm's length with his employer. The distinction between a stockholder dealing with his corporation and an employee with his employer-corporation is not defined in the Opinion, and the distinction is completely obscure. The *Palmer* case is clear that a stockholder may make a bargain purchase if it is not intended as a dividend. The opinion is clear that stockholders by virtue of their relation to their cor-

poration are not to be quarantined from the purchase and sale provisions of the Code. Unless the intention is to pay a dividend, the transaction is a purchase. The Commissioner's regulations with respect to stockholder purchases so read, but do not so read as to employees.

One and one do not make two for stockholders, and three for employees. Unless it is found as a fact that the employee is intended to be compensated by the option, he is as well-entitled to the provisions of Sections 111-113 as the stockholder. From whatever direction the issue is approached, the determination requires fact finding of intention to compensate. This is the function of the courts below, and they concurred in the finding that there was no intention to compensate.

4. *The treatment of the gift aspect is not in accord with prior decisions of the Court.*

The Opinion states "there was not the slightest indication of the kind of detached and disinterested generosity which might evidence a 'gift' in the statutory sense. These transfers of stock bore none of the earmarks of a gift." (Op. p. 3). From this premise, the Opinion then proceeds to the conclusion that the courts below properly refrained from treating the options as gifts.

This description of a gift as requiring "detached and disinterested generosity" is completely contrary to the definition established by the Court in *Helvering* v. *American Dental Co.*, 318 U.S. 322 (1943) and *Commissioner* v. *Jacobson*, 336 U.S. 28 (1949). In both these cases, purely commercial transactions involving dealings governed strictly by business motives were in issue. The rule pronounced by the Court for determining whether a gift occurred had nothing to do with "detached and disinterested generosity",

but is simply whether an effort was made to secure the best price available.

Hence, under the foregoing rule, if the employer tried to get the best price available, there was no intention to compensate and the transaction was a purchase. If the employer did not attempt to get the best price available, there was a gift if there was no intention to compensate. Unless the Court is now discarding the rule of the *American Dental Co.* and *Jacobson* cases, generosity of the employer was not a factor and the issue turns upon its intention or lack of intention to compensate. If, as the Court has previously said, this is a fact to be left with the concurrent determination of the courts below, the taxpayer should prevail.

5. If taxable, the options clearly represented gain either when granted or when notes were given therefor.

The taxpayer agrees that, at a minimum, the income, if any, was realized at the times promissory notes were given by him. But it is submitted that, particularly since the exercise was not dependent upon continued employment, the options obviously had established value and represented gain to the taxpayer at the times granted. See Opinion of Mr. Justice Harlan. Conclusion otherwise is contrary to the well-recognized doctrine of constructive receipt. Certainly a present right to purchase United States Steel stock at 50% of market has real and present value. And since the right here was independent of contigued employment, it bore no relationship to continued rendering of services. Cf. *Morse* v. *Commissioner*, 17 T.C. 1244, aff'd 202 F.2d 69 (CA-2), dealing with taxation of non-assignable annuity contracts delivered to an employee.

In conclusion, attention is directed to the Courts' finding of fact that the employer's intention was to enlist more

efficient service from the taxpayer by making him a part proprietor of the business (Op. p. 4). It is submitted that, even if the two-court finding rule is to be waived, such forward-looking intention where the taxpayer's options were not dependent upon rendering any future service bears such casual and completely unpredictable and uncertain relationship to services as not to be to any extent compensation for services under Section 22(a). The taxpayer in fact terminated his employment shortly after exercise of the options and rendered no more services to his former employer (R. 12). To say that the options were compensation for service which the taxpayer was under no obligation to render and in fact did not render, not only strains the meaning of Section 22(a) unreasonably but also points up the true purchase nature of the transactions. This case would not appear to be one for departure from the two-court finding of fact rule, and the taxpayer believes the Court should reconsider its decision.

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Office - Supreme Court, U. S.
FILED
OCT 28 1955
HAROLD B. WILLEY, Clerk

No. 373.

In the Supreme Court of the United States.

OCTOBER TERM, 1955.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
v.
PHILIP J. LoBUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit.

BRIEF FOR THE RESPONDENT IN OPPOSITION.

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In the Supreme Court of the United States.

October Term, 1955.

No. 373.

Commissioner of Internal Revenue,
Petitioner,
v.
Philip J. LoBue,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit.

BRIEF FOR THE RESPONDENT IN OPPOSITION.

Opinions Below.

The opinion of the Tax Court (R. 51a-59a) is reported at 22 T.C. 440. The opinion of the Court of Appeals is reported at 223 Fed. 2d 367.

Jurisdiction.

The jurisdictional requisites are adequately set forth in the Petition at p. 1. The time for filing this Brief in Opposition has been extended by Order of the Court to November 1, 1955.

Question Presented.

Where an employee is given an option to buy stock in his employer-corporation, with no intention on the part of the corporation thereby to compensate the employee but solely to permit him to acquire a proprietary interest in the corporation, does a purchase of stock at a price less than market value, pursuant to such option, result in taxable income to the employee?

Statutes and Regulations Involved.

The Statute, 26 U.S.C. 22(a), and Regulations, Regs. 111, Section 29.22(a)-1 and Section 29.22(a)-1 [as amended by T.D. 5507], involved are set forth in the Petition at pp. 2, 3 and 4.

Statement.

The facts of the case are adequately summarized in the Petition at pp. 5 through 9 with the exception of the Petitioner's omission of the major fact found by the Tax Court and relied upon by the Third Circuit, that there was no intention on the part of the employer to compensate the taxpayer (Appendix p. 26). An important element of the reasoning of the Third Circuit omitted by the Petitioner is that there must be no intention to compensate the taxpayer (Pet. pp. 8-9).

Argument.

It is submitted that the petition for a writ of certiorari should be denied for the following reasons:

1. This case is of no serious consequence to the Federal revenue. Stock option plans were *de minimis* until the enactment of the "restricted" stock option provisions contained in Section 218 of the Revenue Act of 1950, c. 994, 64 STAT. 906, Section 130A of the Internal Revenue Code of 1939, now Section 421 of the Internal Revenue Code of 1954,

whereby Congress evidenced its intention to allow employees to exercise compensatory options to buy stock in their corporations without being subjected to a tax upon the exercise if certain fixed requirements were met. This favorable legislation made "unrestricted" stock options, such as involved in the present proceedings, of even more minimal significance than before. Statistics show that there were very few stock option plans prior to 1950 and that since that time the great majority of such plans are intended to qualify as restricted options under Section 130A of the 1939 Code, now Section 421 of the 1954 Code. In a Report of a Special Panel to the Salary Stabilization Board dated October 23, 1951, entitled "Stock Option and Stock Option Plans", Item ES 4.2: St 6, it is stated at p. 8:

> ". . . It is clear, however, that the major part of the plans conceived after the enactment of Sec. 130-A in 1950 have been intended to qualify as 'restricted stock options' as defined therein."

In a letter dated July 31, 1951 from the New York Stock Exchange to the Panel, also at p. 8 of the above Report, the Exchange pointed out that stock option plans reported to it in the first six months of 1951 numbered 99 as compared to only 12 for the entire year 1948 and stated:

> "In recent months, most of the plans coming to the attention of the Exchange have been set up as restricted ownership or option under the terms of the amendments to the 1950 tax law."

The Articles cited by the Petitioner do not support its position that this case is of grave importance to the Federal revenue. In fact, quotations taken from these same Articles show that the authors believe that unrestricted stock options, the kind involved in the present proceedings, are no longer important and that it is the "restricted" stock option which is in the ascendency.

(1) *Leake,* "Compensating Executives And The Latest In Stock Options," 32 Taxes 488 (June 1954), states:

> "In the 1950 Revenue Act Congress eased, in a measure, the problem of compensating executive personnel by enactment of Section 130A of the Code, providing for so-called restricted stock options. There was agitation for this remedial legislation as a result of the decision of the Supreme Court in the *Smith* case, and more particularly because of the Commissioner's broad interpretation of that decision, *which led to the virtual abandonment of stock options as a common method of compensating employees.*" (Emphasis supplied.)

(2) *Stryker,* "Do Stock Options Pay," Fortune, December, 1954, p. 118, states:

> "Since 1950 nearly 400 sizable companies—approximately one out of every three listed on the New York Stock Exchange—have offered stock option plans to employees. The great majority of these offers have been of a new type known as 'restricted' options."

(3) "Option Opulence," Wall Street Journal, February 1, 1955, p. 1, states:

> "in the past five years, nearly 500 major companies have granted employees options to purchase stock. . . .
>
> "Congress, in passing the 1950 Revenue Act, opened the gates for the big stock option rush."

(4) *Lyon,* "Capital Gains Benefits Connected With Executive Retirement," Twelfth Annual N.Y.U. Institute on Federal Taxation, p. 365 (1954) at p. 377 states:

> "Beginning almost at once after Section 130A became law, in September 1950, statutory 'restricted' stock options began to be granted on a substantial scale by many major corporations. The extent to which this has taken place is indicated by a number of statistical studies and analyses, including the comprehensive hearings and report of a Special Panel which in late 1951 advised the Salary Stabilization Board on proper rules for treatment of options for stabilization purposes."

(5) *Lasser,* "How To Raise The Take-Home Pay of High-Priced Help Under Today's Wage Freeze And Tax Laws," 93 Journal of Accountancy 166 (Feb. 1952) pp. 171 and 172 states:

> "Stock options are the favorite gimmick just now. . . .
>
> "The rush started in October, 1950, when Congress changed the tax law. In effect, it took stock options out of the ordinary income-tax section, wrapped restrictions around them, and for tax purposes made them capital gains. Hence, the flood of new proposals. . . .
>
> "Most companies today use the 95 per cent options. Many give no bargain rates at all, merely set the price at the market."

(6) *Lloyd,* "Relations Between The Corporation And Its Officers And Employees," 30 Taxes 546 (July 1952) p. 550 states:

> "The period of gestation for stock options proved to be relatively short. The Revenue Act of 1950 was signed by the President on September 23, 1950. Within a period of less than nine months (to July, 1951) more than 75 major corporations had adopted option plans making available more than $400,000,000 in common stock to the officers and employees."

It is noteworthy that, in presenting his undocumented argument as to the serious consequences to the revenue, the Petitioner is silent as to "unrestricted" stock option cases pending before the Internal Revenue Service. The presumption is that there are few, if any. The Tax Court docket as of October 13, 1955, as reported by Commerce Clearing House, shows one employee stock option case pending before such court. CCH Tax Court Reporter, pp. 5901 et seq. (Docket No. 57815).

2. There is no conflict between decisions of the Courts of Appeals. On the contrary, the decision below is in harmony with decisions in similar cases by a number of other

Courts of Appeals. Each decision has turned largely on the facts of the particular case (see Appendix pp. 23, 24, fns. 4 and 5).

3. There is no conflict between the decision below and decisions of this Court. It is not understood that Petitioner claims there is. However, Petitioner claims that there is a conflict in principle between the decision below and decisions of this Court. Petitioner's argument is premised largely on the assumption that the mere exercise of the stock option and the derivation of any economic benefit therefrom resulted in the realization of taxable gain. This merely begs the question.

The Petitioner cites *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, as authority for his conflict in principle argument. According to the Petitioner, this Court in the *Glenshaw* case established the principle that income as defined in Section 22(a) includes all advantageous purchases of property. The Court did not, of course, so hold and such a principle would be completely contrary to basic and long-acknowledged fundamentals of taxation. *Palmer* v. *United States*, 302 U.S. 63. In the *Palmer* case, the favorable exercise of an option to purchase stock in the optioner-corporation was held not to constitute a dividend to the optionee-stockholder, since, in the absence of an intent to pay a dividend, the transaction was merely a non-taxable purchase. *Mayer* v. *Commissioner*, 302 U.S. 647. Inconsistent with his position in the present proceedings, the Petitioner has officially adopted this principle in his regulations:

* * *

> "(b) If property is transferred by a corporation to a shareholder, for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, such shareholder shall include in gross income the difference between the amount paid for the property and the amount of its fair market value *to the extent that such difference is*

in the nature of a distribution of earnings or profits taxable as a dividend.'' (Emphasis supplied.) Regs. 118, Sec. 39.22(a)-1.

The above regulations are inconsistent in principle with those covering the companion employee-purchase situation. By the terms of the latter regulations *every* favorable purchase by an employee is *per se* and without exception compensation for services even though not intended as such. But the Petitioner has been consistently inconsistent. For seven years until 1946, the Petitioner and his regulations were in accord with the courts as to the effect of employee stock options. In 1946, following *Commissioner* v. *Smith,* 324 U.S. 177, and citing the case, he amended his regulations to read as at present (Appendix pp. 22-23). Now, in the present proceedings, the Petitioner has abandoned the *Smith* case as authority for his position (Appendix pp. 22-23) and does not cite the case in his Petition.

The Petitioner asks the Court to uphold his regulations as reasonable and consistent with the statute (Pet. pp. 12-13). At the same time, he illustrates the invalidity of the unconditional rule of the regulations by his admission that gifts by the employer represent one exception.

The Tax Court found as a fact that the employer's intent was to ''give'' the taxpayer a proprietary interest and not to compensate him for services. The purchase of stock thereby was unrelated to ''income derived from salaries, wages or compensation for personal services'' under the language of Section 22(a) and was simply an advantageous purchase opportunity given the taxpayer by his employer.

The Petitioner's economic benefit argument is also inconsistent with his treatment of other employee items, such as group life insurance and board and lodging. Regs. 118, Sec. 29.22(a)-3.

4. The Petitioner argues that the decision of the Court of Appeals (which is merely another decision in a virtually unbroken line of cases, see Pet. p. 20, fn. 1) will frustrate the purpose of Congress in enacting the "restricted" stock option provisions contained in Section 130A of the Internal Revenue Code of 1939, now Section 421 of the Internal Revenue Code of 1954. This is refuted by the fact that practically all of the stock option plans being instituted today are intended to qualify as "restricted" option plans, *supra*, pp. 3, 4 and 5, and by the clear statement of Congress of its intention that unrestricted options continue to be taxed "as under existing law." Senate Finance Committee Report 2375 (81st Cong. 2d Sess.) 1950-2 Int. Rev. Cum. Bull. 483, 526, 552.

As demonstrated above, unrestricted stock options are *de minimis* in significance and the present case arises in a setting which is now largely obsolete, and has been so for over five years.

Conclusion.

For the foregoing reasons, it is submitted that the petition for a writ of certiorari should be denied.

Respectfully submitted,

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